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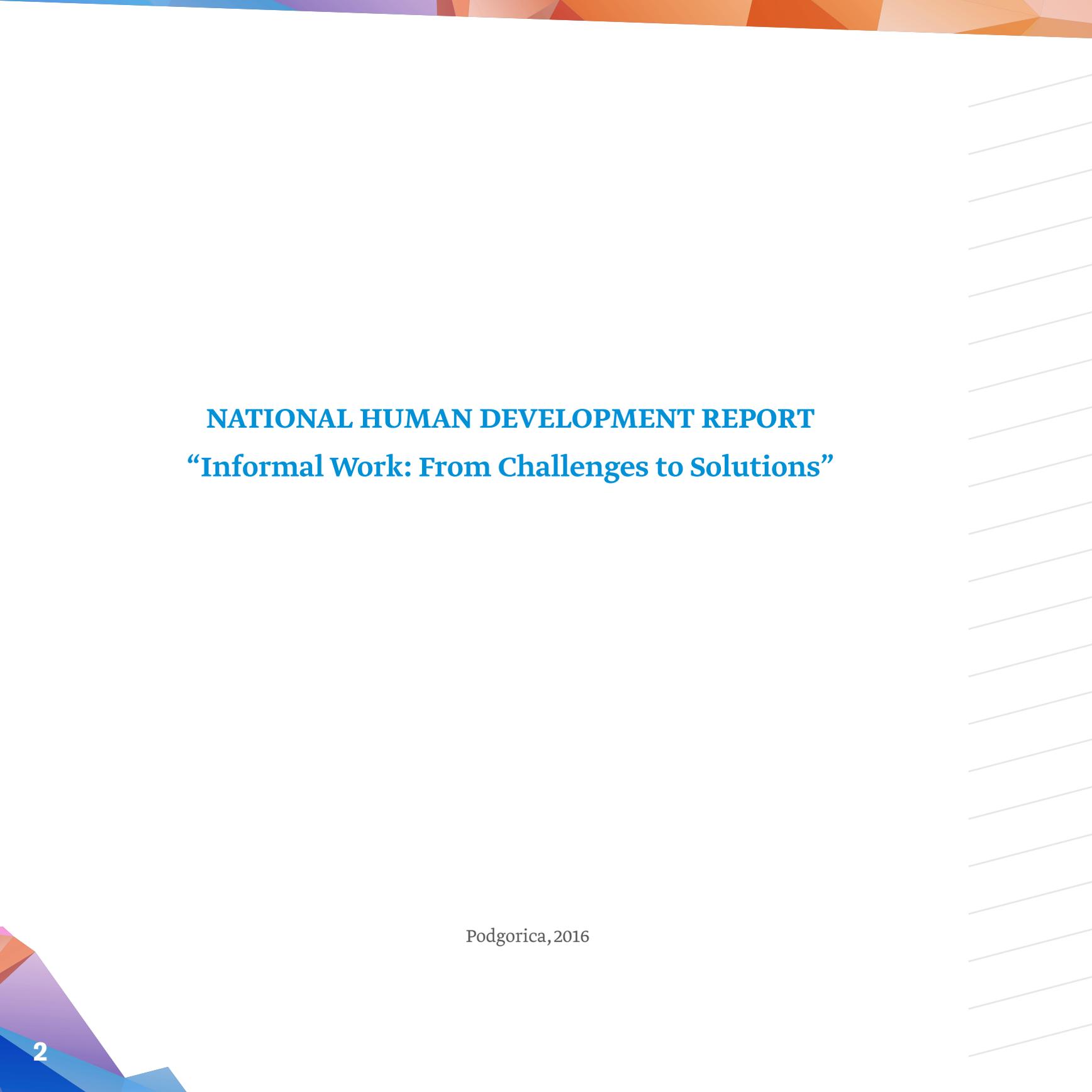


NATIONAL HUMAN
DEVELOPMENT REPORT

Informal work

from challenges to solutions

Podgorica, 2016



NATIONAL HUMAN DEVELOPMENT REPORT
“Informal Work: From Challenges to Solutions”

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Team of authors of the National Human Development Report 2016 - Informal Work

Coordinator and key author: Prof. Milorad Katnić, PhD

Local consultant: Vojin Golubović, MA

Peer review: UNDP Europe and the CIS, Istanbul Regional Center

Translation: Jelena Pralas

Editing: Peter Stonelake

Graphic design, cover page and layout: Bošković and Associates d.o.o.

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This Report was prepared by the expert team hired by UNDP. The key author of the Report is Prof. Milorad Katnić, PhD. The Report is co-authored by Vojin Golubović, MA.¹

The International Labour Organization prepared a separate report – “Creating Conditions for the Shift to Formal Employment in Montenegro” – parts of which are used and/or quoted in this Report. ILO representatives Mauricio Dierckxsens, Sofia Oliveiras and Jasna Poček gave their significant contributions discussing the report structure and providing their verbal suggestions during the consultation process, as well as their written comments on the Draft Report.

Relevant partners participated actively in each stage of the preparation and development of the Report: the Ministry of Labour and Social Welfare, Ministry of Finance, Union of Free Trade Unions of Montenegro, Confederation of Trade Unions of Montenegro and the Union of Employers. The authors of the Report owe a debt of gratitude for cooperation and constructive comments/criticism to: Edina Dešić Perazić from the Ministry of Labour and Social Welfare; Ana Krsmanović, MA, from the Ministry of Finance; Srđa Keković from the Union of Free Trade Unions; and Ana Rašović from the Union of Employers of Montenegro. The authors of the Report highly appreciate all the suggestions provided on the Draft Report by Nina Vujošević, PhD, adviser to the Prime Minister and Tijana Stanković, MA, adviser to the Vice-President of the Government of Montenegro, as well as all the comments from the Ministry of Agriculture and Rural Development and the Ministry of Labour and Social Welfare.

The Report was prepared after the company IPSOS conducted a survey commissioned by UNDP (hereinafter referred to as: “the Survey”). The Survey included several methodological approaches: desk research, a general population survey, a survey that included the representatives of companies and entrepreneurs in Montenegro’s private sector, in-depth interviews with the interested groups and stakeholders in informal employment and the grey economy, and discussions in focus groups with informally employed people. The general population survey (1,038 households) served as the basis for providing an assessment of informal employment and for descriptive and econometric analysis of the characteristics of informally employed persons. The extended sample, which included 119 households living in informal settlements², provided information about whether there is a connection between poverty and informal employment. IPSOS prepared a separate report titled “Informal Employment and the Grey Economy in Montenegro”, the authors of which are Marko Uljarević, Milena Lazić and Gorana Krstić.

1 Vojin Golubović gave his particular contribution by processing the following issues: Economic overview and fiscal sustainability (Chapter 1.3); The informal economy in Montenegro (Chapter 1.4); Informal employment and the education system (Chapter 4.7); Implemented policies aimed at the reduction of informality (Chapter 8.2); and Examples of good practice (Chapter 8.4).

2 Settlements that are not urbanised, e.g. Kakaricka gora or Vrela Ribnička.

In the drafting process, the team organized several rounds of consultations, meetings and round tables with different stakeholders (representatives of the relevant trade union organizations, employers' associations, and state institutions and bodies). The Draft of the Summary Report was discussed in the Government Working Committees, after which it was supported by the Government. It was also discussed in the Social Council, while the Draft Report was discussed and supported in the Sustainable Development Council. In the process of verbal and written consultations and discussions the Draft Report was given numerous positive comments by social partners and members of the Project Steering Committee.

The Union of Free Trade Unions expressed its disagreement with certain views of the Report related to the effects of labour legislation and privatization. However, at the same time, they also gave a positive opinion about the Report, assessing it as “being of high quality, comprehensive and very useful for facing up to the prominent problem of informal labour and the mechanisms for its eradication”.

The authors of the report were highly appreciative of the comments on the Draft Report provided by UNDP representatives Mihail Peleah and Elena Danilova Cross.

The authors of the Report hereby express particular gratitude to the UNDP Office in Podgorica for their trust and for providing the authors with the opportunity to participate in drafting this important document. We owe a particular debt of gratitude to Tomica Paović, Team Leader at the UNDP in Montenegro, for his professional cooperation, support and comments on the Draft Report.

Foreword

When the first Human Development Report was published in 1990, the UNDP firmly set out the concepts of dignity and a decent life as being essential to a broader meaning of human development. In line with this, the UNDP in Montenegro, through its National Human Development Reports, has been drawing the attention of the country's policy-makers and civil society to Montenegro's socio-economic development. The reports have enthused national debates and resulted in numerous initiatives promoting and strengthening sustainable human development.

This year's National Human Development Report tackles the topic of informal work—a pressing topic that affects not only the economy but all segments of society. A third of all people in Montenegro are fully or partly informally hired, which puts them at risk of poor social and health protection. The report offers focused perspectives and an analysis of the national circumstances and strategies for reducing the scale of the informal economy and for advancing human development. The aim of the report is to bring together the facts on human development, influence national policy and mobilize various sectors of the economy and segments of society. It introduces the concept of human development into the national policy dialogue on informal employment—not only through relevant indicators and policy recommendations, but also through the country-led and country-owned processes of consultation, research and report writing.

The NHDR on the informal economy results in a set of policy options on how to reduce the volume of the informal economy in Montenegro with a specific focus on informal employment. In other words, the report's aim is to support the transition to the formal economy. A set of adequate policies and ways to overcome the barriers to formalization were identified, while at the same time taking into account the most common limitations for the transition to the formal economy.

The NHDR has opened the debate on informal employment and its repercussions on inequalities and poverty. To make employment work to reduce poverty, the challenge is not only to create jobs, but also to create decent jobs: ones that offer adequate pay and a sufficient level of social protection. Jobs in the informal sector frequently fail to offer just that. In the context of the unfolding economic crisis it is important that the commitment to poverty reduction is maintained. The recommendations defined in this document that are aimed ultimately at the formalization of labour and at overcoming exclusion and marginalization, are based on a systemic approach and aligned to the Sustainable Development Goals of the 2030 Agenda.

Most of those who work informally are insufficiently protected from the various risks to which they are exposed: illness or health problems, unsafe working conditions and possible loss of earnings. In this context, the NHDR is designed to appeal to a wide audience, to catalyse public debates and mobilize support for action and change, going beyond providing recommendations to reducing the informal work, by influencing the overall structural reforms Montenegro is heading towards.

We believe that this report will inspire decision-makers, as well as employers and employees in Montenegro, on the way forward to shaping a common response in terms of translating its findings into concrete action, while contributing to real transformational change on the ground.



Fiona McCluney,

UNDP Resident Representative
UN Resident Coordinator to Montenegro

EXECUTIVE SUMMARY

The concept of work and the work place has changed significantly, particularly with the development of technology. There are a declining number of jobs that are related to the office and traditional labour organization methods. Taking care of household members, children and the elderly as a form of unpaid and statistically invisible labour is underestimated from the aspect of its impact on and importance for human development. Work and jobs that will be sustainable and the green economy have to be in the focus of attention of decision makers more than used to be the case, and the same can be said for the policies for reorganization of work in a way which enriches human development (Jahan, 2015).

From the perspective of human development it is work, and not jobs or employment, that is the relevant concept. That is why the global Human Development Report for 2015 focuses on work.

The presence of a high proportion of informal work, as a feature of the Montenegrin labour market, highlights the need to create an institutional environment that will motivate the formalization of informal work. That is why this Report analyses the causes and consequences of the informal economy with an emphasis on informal work. In this Report the informal economy and informal work are observed from the perspective of human development, i.e. providing human beings with the opportunity to enjoy long, healthy and creative lives.³ Given the overall context – the historical pattern of economic and cultural development, as well as formal and informal rules in Montenegro – this Report aims to propose that decision-makers use certain effective policies for the formalization of informal employment which will contribute to human development and promote decent work. All of this should be done with full respect for the need to neither limit nor demotivate economic activity. In articulating policies and measures, we took into account not only the specific features of Montenegro, but also the experience gained so far and best international practice.

The preparation of this Report was preceded by the survey carried out by the research agency IPSOS and commissioned by UNDP (hereinafter referred to as: “the Survey”). Several rounds of consultations and round tables were organized with different stakeholders (representatives of trade union organizations, employers’ associations, state institutions and bodies).

Informal employment is a widespread phenomenon that characterizes not only underdeveloped countries with inefficient institutions and a lack of trust in the government. Globally, informal employment is more a rule than an exception, since more than 60% of the total number of employed people globally are employed in the informal economy. Thus Montenegro also has to deal with this phenomenon. The Montenegrin labour market is characterized by low activity among the population that is capable of working, relatively high unemployment, particularly of the young and vulnerable, a lack of new jobs and a lack of high-quality jobs. In addition to this, Montenegro also has so-called negative demographic trends.

3 Mahbub ul Haq (1934–1998) – Founder of the Human Development Report.

According to the Survey's findings, in 2015 one-fifth (22.3%) of the total number of employed people were informally employed, while for one-sixth (10.4%) of the formally employed only a fraction of the taxes and contributions were duly paid (part of their salary was paid as "cash-in-hand"). This means that the total proportion of people who are fully or partly informally hired is at a level of about one-third (32.7%) of the total number of employed people, while the majority of them (two-thirds of informally employed people) are not hired with a formal employer. The data about the proportion of fully or partly informally employed people corresponds to the conclusions obtained by crosschecking various data and methodologies, including MONSTAT data, which also shows that in the last decade the level of informally employed people has been more or less stable somewhere around one-third of the total active working population.

The data on active employed and unemployed people taken from the Labour Force Survey for 2014 conducted by MONSTAT and the data obtained from the Survey on the number of informally employed people point to the conclusion that, if it were not for these informal jobs, the number of unemployed people would be twice as high, significantly increasing the risk of poverty. Although employment in the informal economy is not a desirable type of employment, participation in informal activities reduces inactivity and unemployment in the working population. This fact is particularly important since out of all unregistered employed people in Montenegro, almost 70% are unregistered self-employed people, which indicates how developed small-scale entrepreneurship is within the informal sector.

The informal employment rate is highest among young people (34% for 15-24 year-olds) and the elderly (73% for people 65 years old and older). In addition to this, if we observe only those formally employed people whose taxes and contributions are only partially paid, the largest proportion of such employed people is among young people (15-24 years old) and amounts to 19%. This is the expected U-form of the age structure and it shows that employers choose the most productive workers to be formally employed, while the youngest and oldest workers usually have lower productivity. The informal employment rate is highest among employed people who have not finished primary school or who have finished only primary school. The higher the level of education, the higher the percentage of formally employed people is. The sector that is most affected by informal employment is the sector of other services, followed by trade, agriculture, tourism and construction.

A particular feature of the Montenegrin informal sector is the proportion of social rights beneficiaries, particularly of material allowances for families in the informal sector. A quarter of the beneficiaries of material allowances for families that are able to work fall into the category of unregistered employed people, and they use both the benefits of informal labour and social security.

The high fiscal and para-fiscal burden has been recognized as one of the most significant challenges and obstacles to formality. In addition to the direct impact of the level of tax rates on the characteristics of formal and informal employment, regulation also has an important influence on employment. This is confirmed by the attitudes of the Survey respondents. They think that labour market legislation is

one of the decisive factors when individuals opt for informal employment. Thus, the Montenegrin labour market confirms relevant theoretical and empirical findings (Heckman, Pages, 2004; Lemos 2007; Djankov, 2002) that show that labour market regulation has an impact on the volume of the grey economy through a high cost for job security (cost of dismissal), the level of the minimum wage, regulation of wages, etc. Unequal treatment of companies and entrepreneurs before the law is another cause that employers see as significant for the informal economy and as an obstacle to formalization of employment.

Measures and activities that were carried out in the past with a view to combating informal employment did not have any significant influence on reducing it. Instead of short-term and individual measures, Montenegro needs consistent system changes and long-term dedication to implementing them so that the causes of informal employment can be acted upon and a less painful transfer from unregistered to registered employment ensured. Looking at the bigger picture from the point of view of human development, the most desirable option is that new jobs should be generated in the society and that they are of the highest possible quality. Such jobs would require a convenient, competitive, stable and predictable institutional system, and time. If we only wait for high-quality jobs to become available and if we insist on formalization through repression, a large number of informally employed people will move into the group of inactive people. That would contribute neither to poverty reduction nor to budget revenues or human development. Therefore, any formalization policy has to comprise long-term measures dealing with: (i) improvement of the business environment and improvement of public sector services, so that new and higher quality jobs would be created; (ii) a change to the “false” incentives in the system, so that those who are informally engaged can feel the benefits of formalization; (iii) more efficient work of the inspection bodies; and (iv) promotion of equal rules for everyone, to strengthen trust.

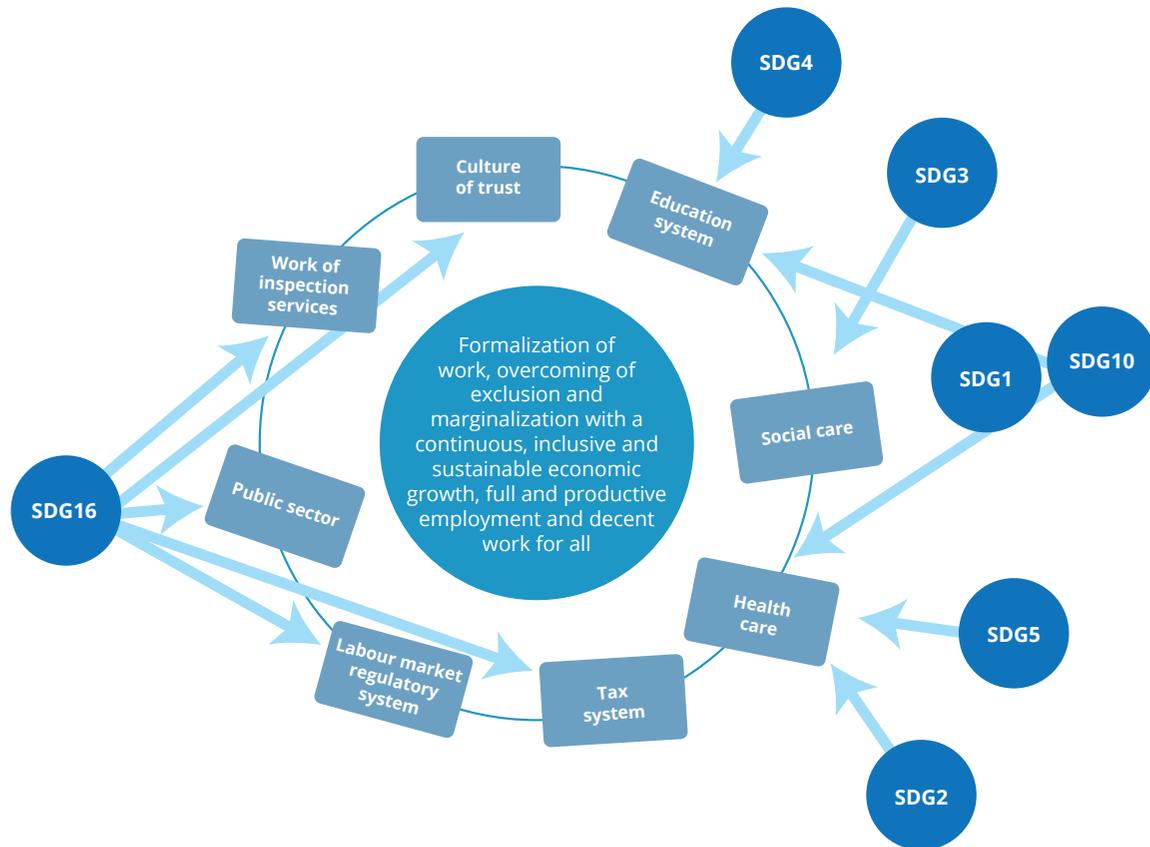
Starting from the above, but primarily based on the reasons and motives for informal work in Montenegro, we can define several (both general and specific) recommendations whose implementation would lead to the formalization of labour and overcoming of exclusion and marginalization.

The recommendations refer to the following reforms and improvements:

- The education system should be inclusive, high-quality and efficient
- Health care should be more accessible, of a higher quality and more efficient
- Incentives for formalization within the social care system should be changed
- The regulatory framework should motivate towards formalization
- Labour legislation should be more flexible
- The public sector has to be more efficient and “fair”

- Tax policy should serve the function of creating preconditions for the generation of new jobs and gradual formalization
- The work of inspection bodies and enforcement of penalties should be improved
- Emphasis should be put on education and creating a culture of trust instead of one of intimidation

The recommendations defined in this document that are aimed ultimately at the formalization of labour and overcoming exclusion and marginalization, are based on a systemic approach. They are based on the Sustainable Development Goals defined in the Agenda for Sustainable Development by 2030.



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LIST OF ABBREVIATIONS

GDP	Gross Domestic Product
GNI	Gross National Income
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
HDI	Human Development Index
IMF	International Monetary Fund
Kosovo*	References to Kosovo shall be understood to be in the context of the Security Council Resolution 1244 (1999)
METR	Marginal Effective Tax Rate
MF	Ministry of Finance
MONSTAT	Statistical Office of Montenegro
ILO	International Labour Organization
OECD	Organisation for Economic Cooperation and Development
VAT	Value Added Tax
pp	Percentage Point
PPP	Purchasing Power Parity
SFRY	Socialist Federal Republic of Yugoslavia
UNDP	United Nations Development Programme
WB	World Bank

INTRODUCTION

“We can’t solve problems by using the same kind of thinking we used when we created them.”

Albert Einstein

The Informal Economy

The informal economy is a widespread social phenomenon that affects both highly developed and underdeveloped countries. It is particularly strong, though, in developing countries. As such, it is a particular challenge for decision-makers at the global and local levels.

In spite of the fact that this phenomenon is so widespread, the research community has not yet reached any consensus regarding either the definition, coverage and causes of the informal economy or methods to measure it. The term “informal economy” has been in use in the academic community and economic policy since the 1970s to depict economic activities outside of the framework of institutions and corporations in the public and private sectors.⁴

The International Labour Organization (ILO) used the term “informal economy” for the first time in its 1972 report about Kenya to refer to activities characterized by simple entry, reliance on one’s own resources, family ownership, small volumes, labour intensive and adaptable technologies, skills acquired outside of the formal sector and a non-regulated market with competition.⁵

Most of the definitions used in academic sources use the term “informal economy” to refer to the undeclared incomes of economic entities, i.e. incomes on which economic entities do not pay the appropriate taxes (VAT, turnover tax, profit tax, etc.), as well as to the failure to register employees. In spite of the fact that this framework is so broad, definitions of the informal economy keep changing and vary from one country to another. The changes are caused by the dynamics of economic processes and the scope of the state regulation that comes with them.

Undeclared work in the labour market is only one of the activities that are carried out within the informal sector, and it is one that is relatively easy to assess and monitor statistically. However, there are various definitions of undeclared work.

⁴ The terms “informal economy” and “informal sector” are most frequently connected with the anthropologist Keith Hart, who studied this phenomenon in Ghana.

⁵ “Employment, Incomes and Equality – a Strategy for Increasing Productive Employment in Kenya” ILO, 1972 http://www.ilo.org/public/libdoc/ilo/1972/72B09_608_engl.pdf.

The OECD defines undeclared employment as activity that is not illegal in itself, but has not been declared to one or several administrative authorities. The European Commission similarly defines the concept of undeclared work as any paid activity that is lawful in its nature but not declared to the public authorities, whereby differences in the regulatory system of Member States must be taken into account.

In its symposium in 1999, the International Labour Organization and International Confederation of Trade Unions proposed a categorization of work in the informal sector into three broad categories:

- Owners - employers in micro-enterprises that employ several paid employees with or without trainees;
- Self-employed people who own single-member businesses, working alone or with the support of unpaid family members; and
- Dependent employees, paid or unpaid, including employees who work for a salary in microenterprises, trainees, employees with contracts, people working from home and paid family workers.

In its Declaration from 2002 - the Resolution regarding decent work and the informal economy - the International Labour Organization observes undeclared work through the informal economy and defines it as: “all economic activities by workers and economic units that are - by law or in practice - not covered or insufficiently covered by formal arrangements”⁶, i.e. employment “which does not comply with the requirements of national laws, regulations and practice”.⁷ According to the ILO’s definition, undeclared work does not include illegal activities, particularly provision of services and production, sale, possession or use of goods prohibited by law, including the illegal production of and trade in drugs, production of and trade in weapons, trafficking in human beings and money laundering, according to the relevant international treaties.

The first international document that tackles the issue of the informal economy - Recommendation No. 204 Concerning the Transition from the Informal to Formal Economy - was adopted in June 2015 by the representatives of governments, employers’ organizations and workers’ organizations at the 104th session of the International Labour Conference. As the starting point/benchmark, this recommendation is the source of guidelines for ILO members to facilitate the transition from the informal to formal economy from the point of view of the principles of decent work. Recommendation No. 204 applies to all employed people and all economic units, including companies, entrepreneurs and households, in the informal economy (Article 4).

6 2002 ILC Declaration on the informal economy.

7 Employment Policy (Supplementary Provisions) Recommendation, 1984 (No. 169).

Causes of the Informal Economy

Economic entities and individuals are motivated to engage in the informal economy if they feel that, in spite of the risks and costs of sanctions, such engagement will bring them higher benefits than formal-sector employment. Legislation can be a constraining factor for working in the formal sector if it is rigid or does not recognize new forms of work.

World Bank research recognizes two basic forms of undeclared work: the first form includes the coping (survival) strategy of individuals who have limited opportunities for generating income and therefore accept to be hired or start their own business within the informal sector; the second form of undeclared work includes rational behaviour of entrepreneurs who want to avoid the burden imposed by legislation. According to the above, the two key forms of undeclared work include: undeclared work as a survival strategy (casual jobs, temporary jobs and subsistence agriculture); and undeclared work aimed at generating undeclared earnings (tax evasion, avoidance of labour regulation and other regulations, and failure to register a company).⁸ Additional forms of informal engagement include illegal activities (crime). These activities are not registered in official statistics and therefore are not included in the generally accepted concept of informal work.

Empirical research into 15 Latin American countries (Loyaza, 1996) that used the MIMIC model⁹ suggests that the key positive influence on the increase of the informal economy comes from the tax burden and rigidity of the labour market, while the intensity and efficiency of institutions have a negative impact on the scale of the informal economy. The stronger and more efficient the institutions are, the smaller the scale of the informal economy is. Later studies (Dell Anno, 2009) reached similar conclusions. As the key cause of the high level of the informal economy, they recognize institutions (efficiency and the rule of law), tax policy (taxation model and the tax rate level), spending policy (the manner in which the state spends money) and human development (the higher this is, the smaller the informal economy is).

Some research into the motives for employment in the grey economy have focused on analysis of the impact of the tax system on the motivation of individuals, as well as on the relation between salaries in the formal and informal economies. The results suggest that higher marginal rates of income tax have a positive impact on undeclared employment, while higher levels of salaries in the formal sector influence a reduction in the undeclared work supply. Similarly, a higher rate of indirect tax and a high marginal income tax rate have a positive impact on the amount of goods and services traded in the informal market (Neck, Schneider and Hofreither, 1989). The tax system does not influence the scale of the informal economy only through the tax rates, but also through its complexity/simplicity (Neck, Schneider, 1993). The more complex the tax system is, the more profitable it is for individuals to try to

8 <http://lnweb90.worldbank.org/eca/eca.nsf/Sectors/ECSPE/2E4EDE543787A0C085256A940073F4E4?OpenDocument>.

9 Multiple Indicators and Multiple Causes model.

evade legal taxation. If they do not manage to evade taxes, they have to pay significant amounts to the government but, in addition, they also have significant administrative costs in complying (time, tax advisers and accountants, paperwork, etc).

The intensity of regulation (IMF, 2006), i.e. the number of different pieces of legislation, licence requests and similar regulations, has a significant impact on the choice of individuals to be hired in areas of the registered economy or to participate in informal activities. Empirical evidence (Johnson, Kaufman, Shleifer, 1997) shows that in countries with more general regulations, the informal economy makes up a larger share of their GDP. Another impact on the weight of the burden, and therefore also on the decision to be engaged in the informal sector, is the effectiveness of the administration in applying regulations. If the Government is ineffective in its implementation of tax regulations, for example, the weight of the burden is smaller, regardless of the tax rates.

Research carried out in 76 countries in transition, both developed and developing ones (Friedman, Johnson, Kaufmann, Zoido-Lobaton, 1999), has shown that the scope of regulations is positively correlated to the scale of the informal economy. An increase in the scope of regulation of 1 index point (the index ranges from 1 to 5) is linked with an increase in the scale of the informal economy of 10%. These findings also suggest that governments should focus more on implementing the existing legislation than on adopting new regulations aimed at reducing the informal economy¹⁰, although sometimes governments decide to increase the volume of legislation, mostly because it increases the power of bureaucracy and leads to a higher employment rate in the public sector.¹¹

The ILO resolution from 2002 - the Resolution on Decent Work and the Informal Economy suggests that organizations of employers and employed people can have a significant role in identifying multiple causes of informality, and also suggests that through three-party actions such causes can be removed. According to the ILO there is a positive correlation between the level of informality on one side and high transaction costs and costs of compliance with the legislation, inadequate legislation and inefficient and corrupted administration on the other. The ILO emphasizes the importance of adequate legislation as an instrument that is “important for recognizing and protecting the rights of workers and employers in the economy”.¹²

A significant source of growth of the burden of legislation and, as such, also an encouragement for doing business in the informal economy, is the uncritical and non-selective “copying” of international practice with a view to achieving faster integration into international organizations and initiatives. In that sense, the process of European integration constitutes a particularly important driver for development of new legislation in Montenegro. It is not unusual for decision-makers, in their wish

10 Friedman, Johnson, Kaufmann, Zoido-Lobaton (1999), Dodging the Grabbing Hand: Determinants of Unofficial Activity in 69 Countries, World Bank.

11 Frey (1989) - How Large (or Small) Should the Underground Economy Be? Cambridge University Press.

12 <http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/pr-25res.pdf>, p. 26.

to ensure harmonization with European directives and recommendations, to “rush” into integration and introduce standards that are inapplicable in Montenegro, because of the current stage in the development of the Montenegrin economy or due to the lack of capacities. This has created quite significant barriers, both for businesses and for the efficient operation of the administration.

In spite of the declared commitment of governments, particularly those of EU Member States, to reduce the administrative burden and in spite of the slogan “one in, two out”, it seems that, in the end, this initiative has been reduced to decreasing the number of pieces of legislation by creating new, more complicated ones, introducing more obligations for businesses and entrepreneurs.¹³

Expansion of new technologies and the possibilities of outsourcing create opportunities for work and jobs that are outside formal legislation, as well as for earning income that is not reported to the tax authorities, which for that reason cannot register or collect it. There is an increasing number of technological “platforms” like Uber, AirBnB and Peer-to-Peer Lending that provide services in an innovative and personalized manner, most frequently in highly regulated sectors. Thus, development of technology has enabled new services to develop, either in compliance with legislation or in avoidance of it. These new services are in direct competition to traditional companies and services, and they contribute to the destruction of the existing monopolies. As a rule, it is the citizens – the beneficiaries of the services – that benefit from this development. Regulated jobs are under pressure from the new competition, while new jobs are generated in an environment of insufficiently defined rules, with the risk that regulators will respond and with pressure from the former monopolists.

The technological revolution and digital technologies have made many occupations redundant. There is a decline in the number of agents that sell tickets, tourist agencies, translators, accountants and similar, while there is an increase in computer programmers and web designers. Programmes and video games have partially replaced conventional toys, balls and dolls. “Smart programmes” and large databases translated into artificial intelligence have been increasingly used for the prevention of numerous diseases. Online education is becoming an increasingly important segment of the education market. Artificial intelligence threatens to replace humans not only in manual work, but also in intellectual work. Many people are afraid that new technologies, the computer revolution, innovation and robotics will reduce demand for human labour and that it will lead to a significant loss in jobs, a decline in incomes and greater inequalities. It is currently evident that a certain number of jobs are disappearing. It is less evident what will be the new jobs to appear in the labour market. Each technological revolution in the past came about with the fear of job losses, and after each of them new work and jobs were generated that, as a rule, were more “intellectual” and more human.

In any case, economic development has changed the scope and character of work. Physical and national borders are less and less recognized by work, particularly intellectual work. Work is becoming

¹³ Among such examples are accountancy directives – two directives being replaced by one – which introduces significantly stricter reporting obligations, imposing new costs for companies.

increasingly international and personalized. It is enough to have a computer connected to the Internet to be able to obtain access to numerous databases and potential purchasers of your intellectual services. The transfer of knowledge is increasingly simple and invisible, and the same can be said for the state registration of labour and for the payment of taxes.

We are entering a new era - an era of technological changes, digitalization and robotics that will be applied to and used in literally every sphere of human life. These significant changes will completely change the paradigm of work and jobs. The entire system will have to adapt, starting from its educational, economic, social and regulatory parts, so that human life and human work can be pursued in the era of the fourth industrial revolution. Furthermore, these changes are needed at the national level so that the citizens of Montenegro, their work and the entire economy can be more productive and competitive.

Consequences of the Informal Economy

The impact of the informal economy on economic activities is both positive and negative. On one hand, the informal economy leads to an increase in economic activities, particularly the economic activities of the population, i.e. their work engagement. However, on the other hand, the informal economy leads to a reduction in (credible and long-term) investments and thus it distorts competition.

When assessing the effects of the informal economy, national economies mostly focus on the fiscal aspects of its influence, i.e. on the potential loss of income and the potential increase of expenditure on social transfers. The economic contribution of those who are employed in the informal economy and their incomes that ensure their “survival” are usually neglected. The informal economy is usually connected with poverty, marginalization and social exclusion of individuals. In this respect, the informal economy does not have only a one-sided impact either. On one hand, incomes from the informal economy reduce the risk of poverty. On the other hand, involvement in the grey economy leads to the “exclusion” of individuals from the system of social protection and to marginalization of individuals engaged in the informal sector. The ILO Resolution from 2002 underlines that this exclusion is particularly important since: “the challenge of reducing decent work deficits is greatest where work is performed outside the scope or application of the legal and institutional frameworks”¹⁴. ILO Recommendation No. 204 underlines in its Preamble that high levels of the informal economy have a negative impact on the sustainable development of companies, public revenues and the government’s economic, social and environmental policy, the sustainability of institutions and fair competition on the national and international markets.

Some of the credible research (Elgin Oztunah, 2012) suggests that the influence of the informal economy on income (GDP per capita) depends on the quality of the institutions. In countries with low-quality

¹⁴ ILO 2002 Resolution, p. 23.

institutions¹⁵ there is a positive correlation between the growth of GDP per capita and the scale of the informal economy, while in countries with high-quality institutions the positive impact of the informal economy on GDP per capita is insignificant. This leads to an important conclusion - that in countries with high-quality institutions, informal business and work, as a rule, do not pay off.

However, this at the same time means that the quality of the institutions does not necessarily increase with economic development and also that the scale of the informal economy does not decrease automatically. The data shows that the scale of the informal economy decreased globally from 25.75% in 1960-70 to 21.67% in the period 2001-09 (Elgin Oztunah, 2012), while global GDP increased five-fold in real value.¹⁶ In addition to this, some studies (IMF, 2006) suggest that the proportion of GDP comprised by the informal economy is lower due to faster growth of the formal economy and not due to the reduction of the informal economy.

Data on the level of informal employment within the labour market presented by OECD in the publication "Is Informal Normal?" shows that 60% of the total number of people employed globally in 2009 were engaged in the informal sector, while 40% were formally employed, i.e. 40% exercised their rights to social insurance - pensions and health insurance.¹⁷ Among the 40% formally employed, there are those who are paid part of their remuneration contrary to the law (in-kind or in cash without paying any of the liabilities to the state). Thus, broadly speaking, the proportion of people fully or partly informally engaged is higher than 60% globally.

Updated data on the number of people informally employed in European countries is unavailable since it is not included in the official statistics. Germany's Institute for the Study of Labour prepared an assessment for 30 European countries (mostly EU members) for 2009 on the basis of labour force surveys¹⁸ and concluded that: informal employment is a significant problem in all parts of Europe and it amounts to 19.2% on average; it is highest in the countries of South-East Europe (28.1% on average) and lowest in Northern European countries (11.8% on average). According to these assessments, Cyprus had the largest proportion of informally employed people of 53%, followed by Greece with 46.7%. Of the Western European countries, the Republic of Ireland and the UK had the largest proportion of informal employment (33% and 21.7% respectively). It is interesting that, according to this research, the smallest proportions of people informally employed were recorded in Lithuania, Latvia and Sweden: 6.4%, 8% and 8.2% respectively.

15 The quality of institutions was assessed by the authors on the basis of the Corruption Perception Index, the rule of law, the efficiency of the administration and the quality of regulation.

16 <http://lnweb90.worldbank.org/eca/eca.nsf/Sectors/ECSPE/2E4EDE543787A0C085256A940073F4E4?OpenDocument>.

17 OECD (2009) - "Is Informal Normal? - Towards More and Better Jobs in Developing Countries".

18 Schneider, F. Buehn, A. Montenegro, C. (2010), New Estimates for the Shadow Economy All over the World, International Economic Journal.

The issue of the informal economy can also be observed from the perspective of informal institutions and their influence. Introduction of the duty to pay taxes in the 19th century in Montenegro was a long and quite laborious task. To begin with, people were not keen to pay taxes regardless of how low they were. They perceived taxes as a form of deprivation of liberty and a form of submission. Today paying taxes is generally acceptable as necessary to ensure the functioning of the state and to ensure state services. Still, many people do not see the benefits of a significant tax burden and/or some of the duties they are required to pay for by law. Modern welfare states have taken on themselves many duties and responsibilities in terms of ensuring social security, redistribution, control over and adjustments to the market and developing an appropriate model of economic growth. Individuals involved in the grey economy (at least some of them) consciously waive the “expensive” services provided by the state – primarily health and social care (pension and unemployment insurance). Frequently they prefer the short-term and direct benefits of a larger income in the present to uncertain (social) benefits and rights in the future. At the same time, these individuals have and use the right to public education and social support that are financed from general revenues, mostly consumption tax.

Regardless of the consequences that the informal economy has on the labour market, which is usually observed by states at the macro level as the proportion of total employment and loss of income, undeclared work has multiple consequences at the micro level and the level of individuals. Although working in the informal sector is usually characterized by lower incomes, lower-quality jobs and worse working conditions, for many individuals it reduces their fear of poverty, influences their economic engagement and ensures subsistence.

In formulating adequate policies for reducing the scale of undeclared work, decision-makers, in consultation with their social partners, should carefully design measures that will ensure a less painful transition from undeclared to declared employment. They should also take into account the fact that not all undeclared work can be formalized. The effects of such policy should have as low a negative impact as possible in terms of the number of jobs. This is particularly important in countries where the work engagement of the population is at a low level, as is the case with Montenegro. In the medium and long term, policies should ensure the generation of as many high-quality jobs in the formal sector as possible.

Report Structure

The executive summary and this introduction are followed by nine chapters.¹⁹ The first chapter, which is titled “Human Development and the Informal Economy”, presents the connection between work and human development and data on the Human Development Index for Montenegro. It also analyses

¹⁹ The Draft Report was larger. It contained some chapter sections that are not included into this report (“Informal Employment and Labour Market Trends” in Chapter 4 and “The Informal Economy and Business Environment” in Chapter 7), while on the other hand, some chapters in this Report have been extended (“The Informal Economy – Gender Aspect” in Chapter 2 and “Compliance of the Recommendations with the 2030 Agenda” in Chapter 9). The final Report is much shorter than the draft so as to comply with the HDR standards.

demographic trends in Montenegro and provides an overview of the economic trends that have marked the last 25 years. Finally, Chapter 1 particularly focuses on presenting the causes of the development of the grey economy and informal employment in Montenegro in the last decades, as well as on the chronology of relevant research undertaken in this field so far.

Chapter 2 deals with an analysis of the profile of Montenegro's informal sector in 2014 using the IPSOS Survey as its basis. The chapter particularly focuses on analysis of informal employment and the issues of the size and character of informal employment, but it also deals with gender, age and other characteristics. Work and employment, as a rule, reduce the risk of poverty. However, the risk of poverty is significantly determined not only by the type of work, but also by its form. Chapter 3 of this Report therefore deals precisely with the issues of poverty, inequality and exclusion. It considers the issue of social transfers and their influence on poverty and formalization.

Chapter 4 discusses the causes and consequences of the informal economy. It presents an overview of the relevant sources and empirical research, and the data from the Survey that refers to Montenegro. A part of this chapter also focuses on the link between informal employment and human development. It also deals with the issue of taxation and regulation of its impact on (informal) employment. The last part of Chapter 4 is dedicated to the issue of education and its impact on employment, both formal and informal.

Productivity and access to capital are central to Chapter 5. The emphasis is put on analysis of the difference between productivity in the formal sector and that in the informal sector, i.e. informal employment. Since the issue of work and deprivation is an issue of global importance, Chapter 6 presents the post-2015 agenda for promotion of productive employment and decent work, as well as the goals of the 2030 Agenda. Global initiatives are connected here with national policies and the findings of the Survey.

Chapter 7 analyses the connection between formal and informal institutions, and informal employment. In this context the chapter emphasizes the important role of development of an encouraging business environment and building of a culture of trust. The challenges of a transition from informal to formal employment are presented in Chapter 8, first through the legal and institutional constraints, and then through the effects of the activities and campaigns that have been undertaken so far. This is followed by a presentation of the current system of incentives and examples of good international practice.

The final chapter, Chapter 9, contains a broader summary of the study's findings, conclusions and recommendations²⁰. The conclusions emphasize the need for development of an institutional environment that will motivate the formalization of work in the informal sector. In wording the

20 The recommendations reflect the findings and opinions of the author and, as a rule, do not have to correspond with the policy and opinion of the party ordering the project – UNDP Office in Podgorica.

policies and measures, we have taken into account specific national features, the experience gained so far, as well as best international practice. Taking into account the profile of the informal sector in Montenegro and particularly the fact that the dominant proportion of the informal sector is made up of self-employed people, policies for the reduction of the scale of undeclared work have been designed in such a way as to ensure the least painful transfer from undeclared to declared employment. This transfer is observed in the context of human development, i.e. the need to make available new jobs that will be of as high a quality as possible. The recommendations defined in the final chapter are based on a systemic approach and are fully in line with the Sustainable Development Goals defined in the 2030 Agenda, which is particularly underlined at the end of this document.

CHAPTER 1: HUMAN DEVELOPMENT AND THE INFORMAL ECONOMY

“Human Development is a process of enlarging people’s choices. In principle, these choices can be infinite and change over time. But at all levels of development, the three essential ones are for people to lead a long and healthy life, to acquire knowledge and to have access to resources needed for a decent standard of living. If these essential choices are not available, many other opportunities remain inaccessible.” (UNDP, 1990)²¹

The Global Human Development Report for 2015 focuses on work. From the perspective of human development the relevant concept is work and not jobs or employment.²² In his presentation on human development, Selim Jahan emphasizes that work is the way to release human potential, creativity and innovativeness but cautions that there is no automatic connection between work and human development.²³ As Jahan emphasizes, not every work has a positive impact on releasing potentials and, therefore, not every work contributes to human development.²⁴

The concepts of work and of the workplace have changed significantly, particularly with the development of technology. There are ever fewer jobs that are tied to the office and traditional ways of organizing work. Taking care of household members, children and the elderly, as a form of unpaid and statistically invisible work, is underestimated from the aspect of its influence and importance for human development. Sustainable work and jobs, as well as the green economy, have to be increasingly in the focus of decision-makers, as well as policies for reorganizing work in such a way that it enriches human development (Jahan, 2015).

The key issue addressed in the Human Development Report is the link between work and human development. Work usually ensures a means of subsistence, social cohesion and human dignity, but there are forms of work that fail to ensure that. In that context, the topic of this Report is understanding the motives and causes of both businesses and individuals for taking part in the informal economy, with a particular focus on the segment of informal work.

The goal is to take into account the overall context, the historical pattern of economic and cultural development, as well as the formal and informal rules in Montenegro and to propose effective formalization policies to decision-makers. Formalization should not be only technical, such as

21 UNDP, 1990, p. 10.

22 Salim Jahan – speech on the Human Development Report for 2015, <http://hdr.undp.org/en/rethinking-work-for-human-development>.

23 Selim Jahan - Director of the UNDP Human Development Report Office.

24 According to the ILO Resolution concerning statistics of work, employment and labour underutilization from 2013, “work comprises any activity performed by people of any sex and age to produce goods or to provide services for use by others or for their own use”. The 2013 Resolution emphasizes that “work is defined irrespective of its formal or informal character or the legality of the activity”, and excludes “activities that do not involve producing goods or services (e.g. begging and stealing), self-care (e.g. personal grooming and hygiene) and activities that cannot be performed by another person on one’s own behalf (e.g. sleeping, learning and activities for one’s own recreation)”.

recording all employed people, but it should be such that it will contribute to human development and promote decent work, respecting the need to neither restrict nor discourage economic activities.

1.1. Trends in Human Development in Montenegro

At the time it gained its independence, Montenegro was in the category of countries with a high human development level, which is characteristic of all the former SFRY republics²⁵. After 2006, the reforms implemented during the transition period and later, as well as the development of the economy, led to a continuous progress in Montenegrin society. Economic growth was followed by improvements in the freedom of choice and opportunities for a high-quality, long and creative life.

Since 2005 Montenegro has been continuously making progress in the components of the HDI and in its overall value. By 2014 it was in the group of countries with a high level of human development. In 2014 Montenegro was for the first time ranked among countries with a very high human development, with an index of 0.802. Thus, since 2014 Montenegro has belonged to the group of the 49 most prosperous countries with a very high level of human development, which, in addition to a certain level of income, also have a framework that ensures that citizens enjoy the benefits of economic growth and conditions for a high-quality, long and creative life.

Table 1.1.1 - Key HD indexes

Year	Life expectancy at birth	Expected number of years of schooling	Mean number of years of schooling	GNI per capita (2011PPP\$)	HDI value
2005	73.6	13.1	10.5	11,210	0.75
2010	75.1	15.2	11.1	13,537	0.792
2011	75.5	15.2	11.2	14,196	0.798
2012	75.8	15.2	11.2	13,958	0.798
2013	76.0	15.2	11.2	14,453	0.801
2014	76.2	15.2	11.2	14,558	0.802

In addition to their economic development and GDP level, the success of nation states in creating a framework for a high-quality and prosperous life for their citizens is also indicated by other components of the HDI. The most illustrative example that shows how economic growth itself does not necessarily mean the highest human development is the change in the ranking of the most developed countries, if we analyse the rank by the value of the Gross National Income per capita and the overall HDI value. Norway, the country with the highest HDI, has a ranking five places higher than its ranking by GNI per

²⁵ In the period after the SFRY fell apart and the transition process started, the value of the Human Development Index in Montenegro decreased primarily because of the negative GDP growth, but even in that period Montenegro was in the group of countries with a high Human Development Index (HDI).

capita. In case of Montenegro, its rank according to its GNI level is 27 places lower than its rank based on all components of human development.

Observed by components, in comparison to pre-referendum 2005, the life expectancy in 2014 is 2.6 years higher than in 2005; the mean years of schooling increased by more than two years, while the ratio of Gross National Income per capita to purchasing power parity increased by about 30%.

If the HDI value for Montenegro is discounted for inequalities, it decreases to 0.728, which is a 9.2% loss. Although significant in percentage terms, this loss is smaller than the average loss of the countries of Europe and Central Asia that have very high HDI values. Thus, the average loss in the value of this index for Europe and Central Asia is 13.0%, while for the group of countries with very high HDIs, the loss due to inequalities is 12.1%. The reason for this is the fact that the inequalities in incomes in Montenegro are significantly lower than in ECA countries (16.6%) and countries with very high HDIs (a reduction of 22.5%).²⁶

Table 1.1.2 - HDI values for selected countries for 2014

Ranking	Countries	HDI 2014	Life expectancy at birth	Mean number of years of schooling	Expected number of years of schooling	GNI per capita (2011 PPP\$)	GNI per capita minus HDI ranking
Very high HDI							
1	Norway	0.944	81.6	17.5	12.6	64,992	5
25	Slovenia	0.880	80.4	16.8	11.9	27,852	12
28	Czech Republic	0.870	78.6	16.4	12.3	26,660	10
30	Estonia	0.861	76.8	16.5	12.5	25,214	12
47	Croatia	0.818	77.3	14.8	11.0	19,409	11
49	Montenegro	0.802	76.2	15.2	11.2	14,558	27
High HDI							
52	Romania	0.793	74.7	14.2	10.8	18,108	10
59	Bulgaria	0.782	74.2	14.4	10.6	15,596	13
66	Serbia	0.771	74.9	14.4	10.5	12,190	20
81	FYR Macedonia	0.747	75.4	13.4	9.3	11,780	9
85	Albania	0.733	77.8	11.8	9.3	9,943	14
85	Bosnia and Herzegovina	0.733	76.5	13.6	8.3	9,638	19

Source: UNDP, 2015

²⁶ Inequalities in income show the difference between the income of the wealthiest 10% of the population and the poorest 10%.

Norway had the highest HDI in 2014 of 0.944. In comparison to Montenegro, Norway had a life expectancy at birth 5.4 years higher, the mean number of years of schooling is 2.3 years higher, while the income per capita expressed in purchasing power parity is more than four times as high. In the overall index and also in all the individual components Norway is a role model not only for Montenegro, but also for all the former SFRY countries.

Observed by the value of the overall index, Montenegro is significantly above-average in the region of Europe and Central Asia, and it sits in 49th place globally. In comparison to the countries of the former SFRY, in 2014 Montenegro joined the countries with a very high HDI, being only two positions behind Croatia (which moved into 47th place), and 24 positions behind Slovenia (which is 25th). The group of countries with a high human development includes Serbia (66th place), FYR Macedonia (81st place) and Bosnia and Herzegovina (85th place).

The Global Human Development Report from 2010 introduced the Gender Inequality Index (GII) that reflects inequalities in three dimensions - reproductive health, empowerment and economic activity. In 2014 the value of GII was 0.172, which ensured Montenegro a position of 37th out of the 155 countries covered by the report and showed that inequalities between genders are not significantly present in Montenegro.

The global Human Development Report for 2015 reintroduced the indicator of a gender-disaggregated Human Development Index or Gender Development Index (GDI)²⁷. It measures achievements in the three key components of human development: health, education and command over economic resources. The HDI value for women is 0.782, while the HDI value for men is 0.819, which gives a GDI value of 0.954. This index shows that there is a certain gap between genders in the field of human development. The value of GDI for Montenegro is slightly higher than average in the countries of Europe and Central Asia (GDI: 0.945), while it is lower than for the countries with a very high HDI (GDI: 0.978).

The Multidimensional Poverty Index (MPI) completes the picture of the situation of human development in Montenegro. It measures multiple deprivations in the same households in education, health and living standards. Data available for Montenegro from 2013 shows that 0.5% of the population, or about 3,000 individuals, were exposed to multidimensional poverty. These individuals have low incomes and have no access to healthcare services and education.

1.2. Demographic Trends in Montenegro

The demographic picture of Montenegro has changed significantly in the last 30 years, just as it has in the rest of Europe. On average, the population is living longer and is older.²⁸ However, in comparison

²⁷ This index was introduced in the mid-90s but was abandoned in 2010.

²⁸ The average age for women in 1971 was 29.8, and for men was 27.4, while in 2011 the average age for women was 38.4, and for men 36 years.

to the countries of the European Union, Montenegro has a much younger population. According to Eurostat data, the median age in the European Union in 2014 was 42.2 years, while in Montenegro, according to the same data, it was much lower and amounted to 37.4 years.²⁹ In the last 10 years the median age in Montenegro has increased by 2.5 years, while in EU it has grown by 3 years.

Figure 1.2.1 - Age structure of the population (%)

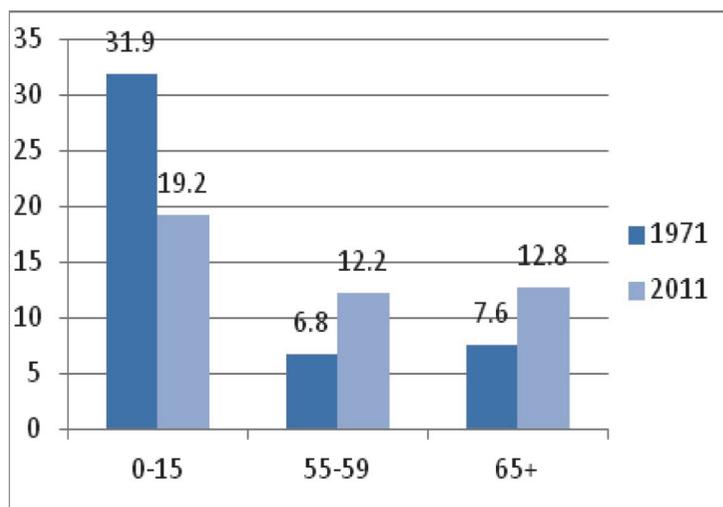
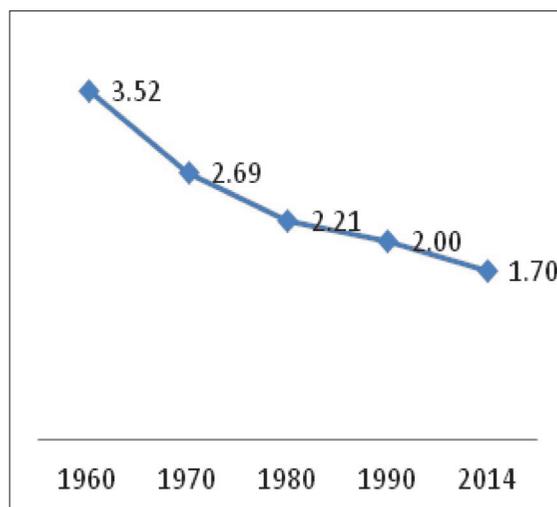


Figure 1.2.2 - General fertility rate



Source: MONSTAT

In the period from 2005 to 2014, according to Eurostat data, life expectancy at birth rose in Montenegro by 2.2 years, from 73.6 to 75.8, while in the EU it grew by 2 years, from 77.9 to 79.9. In the same period Montenegro also recorded an increase in the life expectancy at the age of 65 from 15.0 to 16.3, while life expectancy at 65 in the EU increased from 18.3 to 19.8 years.

Expected demographic trends are reflected in the gradual ageing of the population, an increase in life expectancy and the birth rate, and a decrease in fertility. The expected life expectancy at birth is projected to reach 83.6 by 2060. It is currently 75.8. The increase in life expectancy will be followed by an increase in the dependency ratio³⁰ from 19.6% in 2011 to 38.0% in 2060.³¹

The proportion of the population under 15 years of age was 31.9% in 1971. In 2011 this proportion shrank by approximately 13pp to 19.2%. At the same time, the proportion of the population aged 65 and above almost doubled - from 7.6% to 12.8% of the total population.

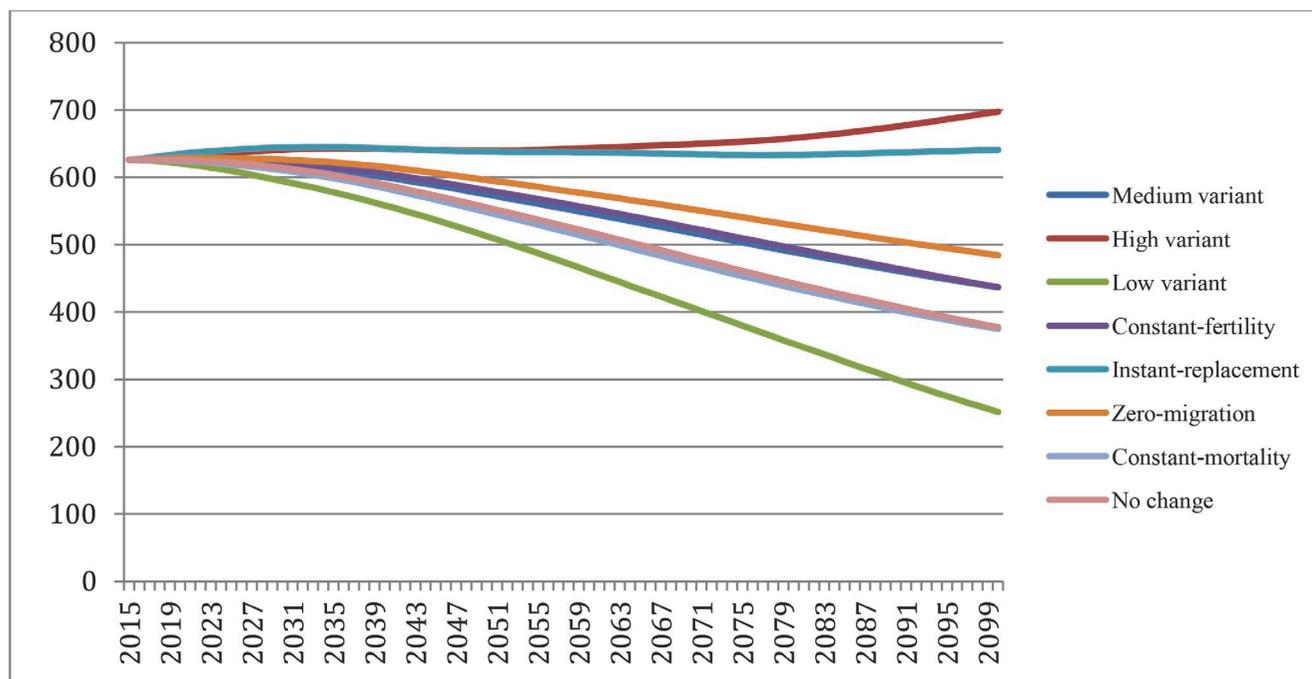
²⁹ The median value is the value that is in the middle of the group of numbers ordered by size and it splits the group into two: 50% above the median value and 50% below the median value.

³⁰ The dependency ratio (old-age dependency ratio) is the ratio of the population older than 65 to the working-age population.

³¹ Čok, M. Sambt, J. (2011), Montenegro: Projection of Categories Related to the Pension System, University of Ljubljana.

World War II had a significant impact on the demographic trends and this situation in 1971, as well as on the significant fertility growth that was recorded in all countries. The declining trend of the fertility rate has slowed down, but is still present. In the period from 1990 to 2014 the fertility rate in Montenegro declined by 15%, while in comparison to 1980 it declined by approximately 25%.

Figure 1.2.3 - UN population projections



Source: UN World Population Prospects: A 2015 Revision

Demographic trends in Montenegro suggest that there is an increase in cost related to the process of the ageing of the population, particularly in the pension system and the system of health care and long-term care. This is particularly true for the system of pension insurance based on inter-generational solidarity, where the existing employed population finances the existing retired population. Ageing of the population that leads to a consequential reduction in the size of the working population and an increase in the number of retired people becomes increasingly important given the scope of undeclared work and practice not of declaring part of the remuneration, as is the case in Montenegro's economy.

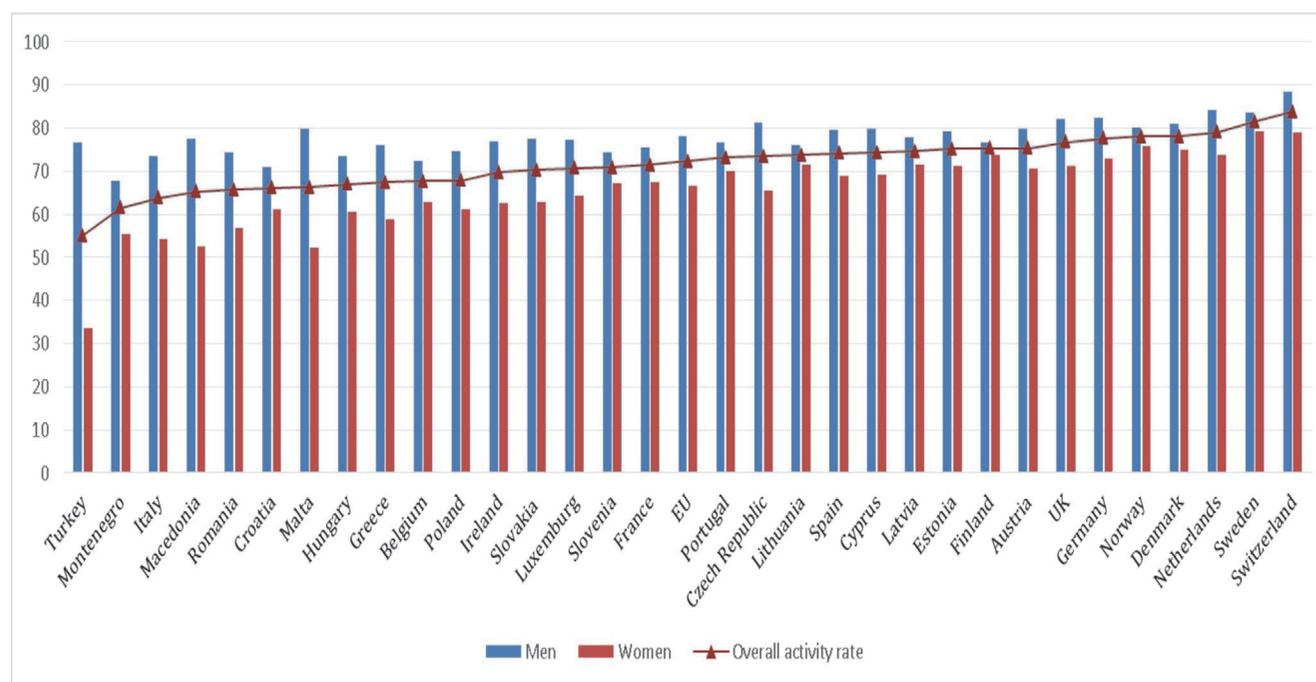
The revised UN population projections from 2015 also indicate the importance of demographic trends and the need to pay particular attention to them.³² According to these projections, the Montenegrin

³² See: <http://esa.un.org/unpd/wpp/>.

population will most probably start decreasing sometime around 2030. Montenegro's population would increase only with high or medium growth levels, which is not very likely to happen. All other assumptions suggest that Montenegro's population will decrease.

Demographic trends and a high level of undeclared work can lead to an increase in the vulnerability of the elderly population at the moment when they become inactive, primarily due to lower incomes from pensions or a lack of such incomes in case they do not meet the requirements for a pension (a minimum 15 years of declared labour for which contributions were paid). In addition to the existing pension system, the reduced working population and a particularly low level of labour activity (about 50% of population over 15 is active), the key challenges for decision-makers include formalization of the existing jobs in the informal economy and, maybe even more importantly, increasing the activity of the population over 15 years of age.

Figure 1.2.4. - Activity rate for the population age 15-64 in EU and Montenegro by gender (% of the working population)

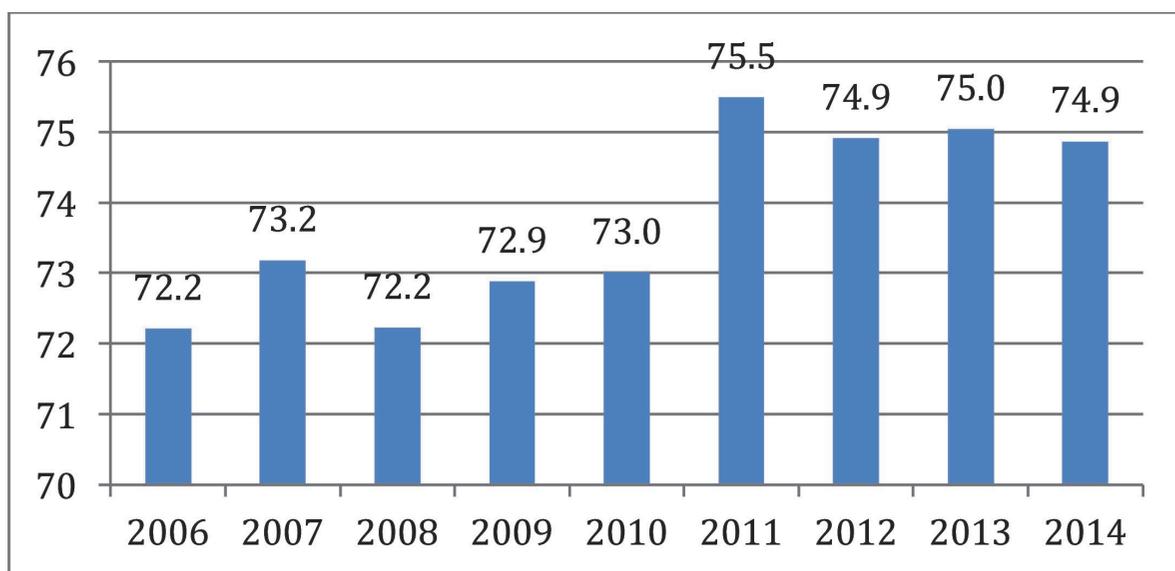


Source: EUROSTAT, MONSTAT

The working population (15-64) activity rate in Montenegro is 10 percentage points lower than the average in the European Union. With the current demographic trends and the fact that the population is shrinking, primarily the younger cohorts, if the policies remain unchanged we can expect larger

expenditures on social contributions in the future. At the same time, a high inactivity rate and the fact that every year a large number of non-residents (mostly unqualified and with lower education levels) are employed in Montenegro, may imply that the existing social protection system is too generous, and/or that there is strong solidarity within families. The data is even more alarming if we observe the relationship between the activity rate for women and for men. Although the gap is reducing, it is still significant. The activity rate for men who are able to work in Montenegro is the lowest in Europe, while the gap between men and women, although significant, is only 3pp higher than the EU average.

Figure 1.2.5 - Ratio between activity rates for women and men 15-64 (%)



Source: World Development Indicators, SB, 2015

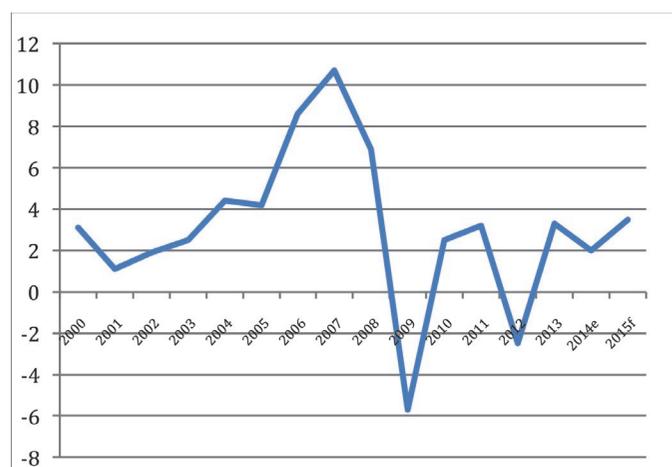
There are concerns that have been raised by the frequent changes in policies that are not part of a systemic approach and whose consequences have not been carefully analysed. They are often ad hoc solutions motivated by particular interests or the need to score political points. In such a situation the overall system becomes more unstable and more unpredictable, while individuals are not encouraged to engage in real work activity, but in activities of looking for loopholes in the system. Thus, for example, regulatory changes in the social care system that were adopted in 2015 (special requirements for retirement, benefits for mothers and similar benefits) do not only pose a fiscal problem, but also give a negative incentive to all participants in the labour market. Such a policy sends the message to the citizens that it is sufficient to belong to a certain group of the employed population to acquire privileges and to “escape” into inactivity and the informal sector. In such circumstances, the pressure to keep one’s job and to work can be lower since a guaranteed income is always there. In addition to

this, the recorded trend of a reduction in the gap between men and women in their activity in the labour market will reverse and the gap will deepen.

1.3. Economic Trends

In 1990s, due to the consequences of wars, sanctions and economic and social degradation in the country, GDP in Montenegro recorded its highest negative growth rates. In 1992 and 1993 Montenegrin GDP fell by almost 50% in comparison to the pre-transition period. In the period after 1994, GDP recorded positive annual growth rates until 1999. Due to the Kosovo* crisis and NATO bombing, in 1999 Montenegrin GDP recorded a decline of 8.3% compared to 1998 levels. After the turbulent 1990s numerous reforms were undertaken and structural changes made in the area of monetary and fiscal policy, trade liberalization and incentives to the private sector and private initiatives. They led to the acceleration of economic growth in Montenegro. The key development goals of the economic reforms included: the growth of economic freedoms and a strengthening of the role of the private sector; a strengthening of the rule of law as a precondition for the development of modern institutions of parliamentary democracy; and an improvement of the living standard of citizens through the offer of high-quality public services, through more efficient systems of education, health and social care.

Figure 1.3.1 - Real GDP growth rate (%)



After the restoration of its independence, Montenegro made great progress in both the political and economic fields, which was reflected in a significantly more open market economy and the strengthening of democratic institutions. In parallel with the strengthening of the existing institutions and building of new ones, the Montenegrin economy continued its transformation into an open, market economy. Right up until the global economic crisis spilled over in 2009, the Montenegrin economy recorded the highest real economic growth rates in the region and in Europe.

Source: MONSTAT, MF

Economic liberalization, macroeconomic stabilization and the creation of a more competitive business environment led to the inflow of a significant amount of Foreign Direct Investment (FDI), which ensured high rates of economic growth in the pre-crisis period. The level of FDI grew in 2008 when the net inflow of FDI was 18.4% of GDP. In 2009 FDI comprised about 30% of GDP, while in the years that

followed, under the influence of the global financial crisis, the inflow of FDI fell significantly to reach €353.94 million in 2014 or 10.2% of GDP.

In the last 15 years, the structure of the Montenegrin economy has changed in such a way that services, as a percentage of total GDP, increased while industrial production decreased. Agriculture, as a percentage of GDP, fell from 11.3% in 2002 to 8.1% in 2014. In 2002 industrial production made up almost 20% of GDP and in 2014 the industrial sector accounted for about 9.8% of the total generated value in the economy.

Since 2000 the annual GDP growth rates have been mostly positive. The largest real GDP growth rates in the last decade were achieved in 2006 and 2007 – 8.6% and 10.7% respectively.

After the record-breaking three-year growth of real GDP in the period 2006–2008, Montenegro faced the consequences of the global crisis and negative growth in 2009. The consequences of the crisis were strong and they had long-term implications for the lives of citizens. EBRD data shows that in 2010 about 60% of households were affected by the economic crisis, which is about 10% higher than the average in transition countries and twice as high as the average for Western European countries. Least affected by the crisis were citizens over 60 and members of higher-income groups.³³

Table 1.3.1 – Real GDP growth, World Bank³⁴

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Montenegro	4.0	8.4	10.5	6.8	-5.8	2.4	3.1	-2.6	3.3	1.8
Albania	6.3	5.9	6.9	8.6	4.4	4.7	3.5	2.6	2.4	2.1
B&H	5.2	6.3	7	5.6	-2.7	0.9	1.1	-1.1	2.6	0.8
Croatia	4.1	4.8	5.2	2.1	-7.3	-1.4	2.9	-1.9	-0.6	-0.4
Kosovo*	6	5.4	3.7	2.8	2.5	3.6	1.9	2.5	2.0	1.0
FYR Macedonia	4.1	4.8	6	4.8	-1	2.8	2.7	-0.5	3.0	3.8
Serbia	5.9	5.3	6.3	5.8	-2.7	1	2.2	-0.5	3.1	-1.8

Source: World Bank

The dramatic decline in economic activities and the crisis in the financial sector in 2009 were followed by years of adjustments and stabilization. The years 2010 and 2011 were marked by slight growth that was interrupted by the second recession wave in 2012. Finally, in 2013 the region recorded an average growth of 2%. World Bank data suggests that in 2013 Montenegro had faster-than-average growth compared to its neighbouring countries. In 2014 it was slower.³⁵ In the medium term, over the three-

33 <http://www.ebrd.com/news/publications/special-reports/life-in-transition-survey-ii.html>.

34 <http://data.worldbank.org/indicator/NY.GDP.PCAP.KD.ZG>.

35 World Bank, Regional Economic Report. The average refers to Montenegro, Albania, Bosnia and Herzegovina, Kosovo*, FYR Macedonia and Serbia.

year period of 2015–2017 Montenegro is expected to accelerate its economic growth to reach 3% on average.

In the period from 2000 to 2009 the nominal GDP per capita in Montenegro grew. In 2000 the GDP per capita amounted to €1,673.07 and by 2001 it had reached the amount of €2,113.00. The growth trend continued in the years that followed and thus at the end of 2014 Montenegrin GDP per capita amounted to €5,561.

1.4. The Informal Economy in Montenegro³⁶

In the period before the 1990s, within the SFRY, the Montenegrin economy was organized as a centrally planned economy. The trade flows with foreign countries were controlled and the supply of goods and services was limited. The state had the dominant role in the economy. Economic activities were organized in the sector of state/socially owned companies, while private initiative was discouraged. All of this was a very favourable environment for the informal economy that was limited through repressive mechanisms of control. Some research shows that in the years before transition, the level of informal employment and undeclared work was around 5% and it was based on sporadic personal services such as small-scale craftwork and growing agricultural products.³⁷ Since there were almost no private companies, it was easy for the labour inspectorate to detect informal activities.

In addition to the wars in the 1990s, economic activities were limited or made impossible by UN sanctions, because the legal exchange of money and goods with foreign countries was either blocked or limited. That additionally stimulated the growth of the informal economy. The macroeconomic picture was characterized by negative GDP growth rates, high inflation, a decline in purchasing power, high unemployment, credit indebtedness, low salaries, high taxes and contributions, a decline in the quality of provision of public services, huge bureaucracy and inefficient implementation of legislation. With a view to ensuring social peace, the state tolerated certain activities in the informal sector. Some research suggests that in 1991 the level of the informal economy in Montenegro amounted to more than 40%.³⁸

36 The body of research into the phenomenon of the informal economy is small in Montenegro, just like in other economies. It mostly deals with analysing the informal economy from different perspectives, using various methodologies. However, in spite of the impossibility of comparing research, the results give a certain picture about the development of the informal sector and about the conditions that contributed to the development of the informal sector.

37 A Comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova and Montenegro, C. Mihes, p. 49.

38 "The Informal Economy and Unprotected Work in Montenegro", The Confederation of Independent Trade Unions of Montenegro, 2002.

Figure 1.4.1 - Factors of the informal economy



Source: Informal Economy and Unprotected Work in Montenegro, The Confederation of Independent Trade Unions of Montenegro, 2002.

In addition to the external factors that were conducive to the development of the informal economy in Montenegro, i.e. the wars and sanctions, some internal factors were also important. First of all, the legislative framework was such that it imposed fixed costs on all participants in the economy. Informal economic activity and informal employment in Montenegro most frequently appeared in the low-profit, labour-intensive sectors, such as retail, construction, hospitality industry, transport, agriculture and domestic services, which are more difficult to control.

Participants in the grey economy are usually the owners of smaller companies that hire undeclared workers, declare less income from their business operations or else do not declare income at all, evade taxes, etc. In addition to such companies, some participants in the grey economy are self-employed people that work on their own or with the support of their family members, traders at open markets or improvised stands in the streets or next to the road (selling fruit, vegetable, textiles and groceries), carpet

cleaners, cleaners in households, people who provide care for the elderly or children, craftspeople, i.e. those who carry out household repairs, people that provide consultancy services through the Internet, people who provide private tutoring to pupils or students, etc.

1.4.1. Development of Informality in Time, Followed through Empirical Research

The first research dealing with the level of the informal economy in Montenegro, its forms, causes and consequences was undertaken at the end of the 20th century and the beginning of the 21st. The estimated level of the informal economy in Montenegro during the 1990s and at the beginning of the 2000s ranged between 35% and 60% of the Gross Domestic Product.

In the 2000s the Centre for Development of Industrial Democracy carried out a survey about the labour law and social position of employees in the so-called small private sector, through which this issue was also analysed. The results suggest that 38.59% of employees in the sectors of hospitality, trade and construction worked in the informal sector. Almost one-third of the respondents had worked in the informal market for more than two years, and there were more women than men among these informally employed people. As for the age structure, just as today, those that were most likely to be working in the informal economy were the young and the elderly.

An assessment of the Institute for Strategic Studies and Projections has shown that in 2001 the size of the informal economy amounted to 40% of GDP, while in 2002 it was at a level of 30% of GDP.³⁹ UNDP's assessment for 2002 shows that the real unemployment rate was lower than the official one, while the estimate is that 25.5% of the active population had undeclared incomes and that 18% of them performed more than one job.⁴⁰

One of the important pieces of research in the field of the informal economy and its presence in the labour market is the research and analysis titled "The Informal Economy and Unprotected Work in Montenegro" that was undertaken in late 2002 by a group of experts from the Centre for Development of Industrial Democracy in Podgorica for the Confederation of Independent Trade Unions of Montenegro.

This research found out that in 2002:

- Of the workers who were using their mandatory annual leave, about 40-50%, or about 6,000 workers, worked in the grey economy
- Of the total number of people unemployed, 30-40%, or about 30,000, did not declare their employment
- Of the total number of retired people, 10-12%, or about 8,700, worked in the grey economy

³⁹ For details see the publication Montenegrian Economic Trends and Survey of Households at www.isspm.org.

⁴⁰ INCI (International Nomenclature of Cosmetic Ingredients).

- Of the total number of refugees and displaced persons capable of working, 30–35%, or about 10,000, worked in the grey economy
- Between 5,000 and 10,000 workers from abroad were hired informally to do certain jobs, primarily seasonal

This data shows that in the observed period about 50,000 to 65,000 workers were employed, either in the formal or informal economy (unofficial or illegal) sector. Observed by gender, a slightly higher number of men were employed informally (50.7%), while observed by the age structure, the largest number of people informally employed were young, i.e. under 25 (36.5%) or elderly – over 55 (44.4%). If we take into account the qualification structure of employees, then according to the research, informal employment was most common with people who have only primary-school-level (47%), and secondary-school-level education (42.8%), while among those employed who have higher levels of education, 11.5% worked informally. Observed through the perspective of occupations, the groups of occupations where informal employment was most common include construction workers, waiters and shop assistants. The least frequent occupations in informal employment were administrative workers. Observed by sectors, the strongest presence of the informal economy was recorded in the hospitality industry (31.6%), construction (38.5%), trade (25.7%), and transportation (17.6%).

In addition to the above structural data, some of the important information obtained in this comprehensive research includes the following:

- 63.4% of employers say that the main reason for informal employment is having to pay high taxes and contributions on the salaries of their employees, while 17.1% held the opinion that it was more difficult to ensure that labour followed the procedures and deadlines required in the legislation
- 48.7% of the workers that participated in the survey did not do jobs within the field of their occupations, while 33.6% of the employers that participated in the survey did not carry out the activities their companies were registered for
- A large number of women (56%) did not do a job within the occupation they studied for
- 61.76% of workers who used to work informally did not do jobs in the field of their occupation, and the majority of waiters and shop assistants were not educated for the jobs that they performed
- 39.4% of informal employees that participated in the survey were hired informally for more than two years
- 32.3% of workers that were informally employed were not registered in the Employment Office's records at all
- Of the total number of employers that paid contributions, the majority (60.6%) paid taxes and contributions on the minimum wage only⁴¹

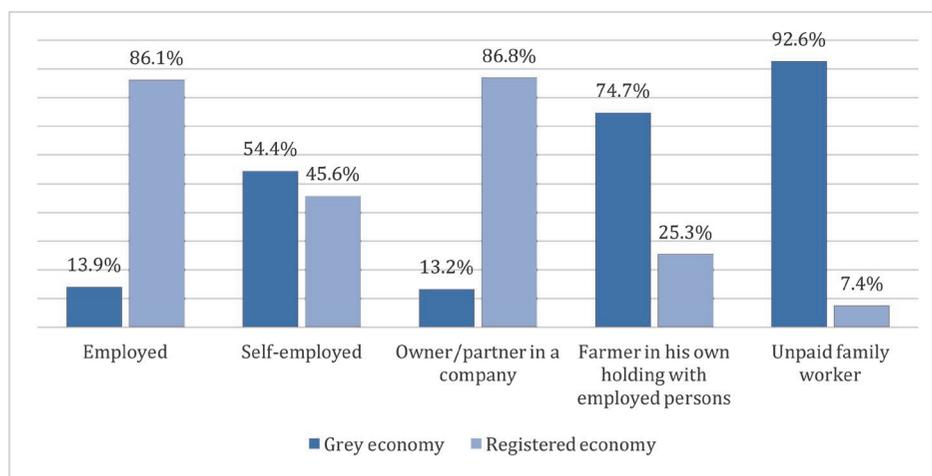
41 "Informal Economy and Unprotected Work in Montenegro", The Confederation of Independent Trade Unions of Montenegro, pp. 22-45.

This study provoked numerous questions related to the consequences of informal employment and doing business in Montenegro. However, it also highlighted issues such as the fact that the education system is not in line with the real needs of the labour market and that informal work tends to be a long-term condition, which leads to the social exclusion of certain population groups. The study suggested that informal employment and those participating in it have become a “surrogate of the system”, i.e. a system parallel to the regular labour market.

A slight decline in the size of informal economy out of the total value of the economy was recorded in 2005. On the basis of the survey (Omnibus survey, December 2005, ISSP) that was conducted by the Institute for Strategic Studies and Projections in Montenegro in 2005, the size of the informal economy was 25% of GDP or about €400 million. The results show that the informal economy’s presence was stronger in the poorer parts of Montenegro. Thus, 30.6% of the informal economy was recorded in the coastal region, 23.8% in the central region and 45.6% in the northern region of Montenegro, where the poverty rate is higher than in the other two regions. The key sectors where grey economy activities were recorded included trade (38.1%), agriculture (18.2%), the hospitality industry (19.1%), the construction industry (10.8%), and transportation (9.6%). Workers with low qualifications comprised a larger proportion of the grey economy during the season.

Results show that a total of 22.6% of employees were hired in the informal economy (either working in unregistered companies or as unregistered workers in registered companies), while of the total number of registered employees, 17.5% had only part of their salaries declared. This means that almost 50,000 people out of the 220,000 people employed were not registered in either the formal or informal economy. At the same time 13.2% of owners and co-owners of businesses operated in the informal economy.

Figure 1.4.1.1 - Structure of people employed by their position or engagement in the grey and registered economy



Source: Institute for Strategic Studies and Projections, Employment Office of Montenegro (2007),
Labour Force and Employment in Montenegro

About 31,000 workers in Montenegro had only part of their salaries declared. This is more than 15% of the total number of employees that work within the formal economy. For this group of employed people, employers declare on average 57.4% of the total amount of their salaries.

In the structure of informal employees, 40% were women, and the largest proportion of people engaged in the grey economy were in the age group 20–29 (32.7%). This indicates that young people entering the labour market have the strongest inclination towards informal employment. As such, they do not enjoy appropriate protection. The survey also showed a large level of participation in the grey economy by people in the age groups of 30–34 (11.8%), 35–39 (11.6%) and 50–54 (11.9%).

The results show that the highest levels of employees in the grey economy were recorded for hotels and restaurants (19.1%), agriculture (18.0%), wholesale and retail (15.7%), while the lowest levels were recorded in the renting of property (0.2%), electricity supply, water and gas supply (0.7%), the health sector (0.7%) and financial mediation (0.9%).

The study *Strengthening of Social Dialogue in Montenegro - Reducing Undeclared Labour and the Grey Economy through Social Partnership* was conducted in 2009. Its goal was to assess the scale and structure of informal employment⁴² and it showed that at the time of the study undeclared work made up 15–20% of total employment in Montenegro. The regional study conducted by the International Labour Organization in 2011 showed that 77% of all those informally employed in Montenegro are working in the formal economy, while 23% are working in the informal economy.⁴³ As for the status of employment, 15.8% of all informal workers in Montenegro are self-employed, while the bulk of informal employment takes place in the formal sector. This shows that the nature of informal employment significantly differs from that in some of the other countries covered by this study, where informal employment of self-employed people is prevalent. Just like certain other research studies, this one confirmed that there are more men than women in informal employment.

According to the ILO report *Global Employment Trends in 2013*, Montenegro recorded certain progress in some of the labour market indicators. However, growth in informal employment still exists. According to this report this trend is also recorded for other countries in the region. The research showed that Montenegro had recorded an increase in the level of people informally employed from 17% to 19% in the period 2000–2010.

A study by the European Movement in Montenegro titled “The Social and Economic Position of Women in Montenegro” (2011) dealt to a certain extent with the issue of the position of women in the labour market. The goal of the study was to use different methodologies, including focus groups, to provide a comprehensive and detailed description of the position of women in various areas of private and social life in Montenegro. One of the conclusions was that women in Montenegrin society are faced with a

42 Implementation of this study was financed by the International Labour Organization (ILO).

43 ILO – A Comparative Overview of Informal Employment in Albania, Bosnia and Herzegovina, Moldova and Montenegro.

large number of problems in numerous domains of private and public life, including the labour market, because employment among the female population is characterized by more frequent acceptance of jobs that are poorly paid, temporary or have worse working conditions. The study also concluded that the conditions for the development of entrepreneurship were still less favourable for women than for men, which is a result of the still deeply rooted patriarchal attitudes of the Montenegrin population and some other factors, such as differences in property ownership, which make it difficult for women to start their own businesses.

The study “The Social and Economic Position of Women in Montenegro” also presented data collected from focus groups of women employed in the grey economy. They said that under the pressure of unemployment, the poor economic situation, etc. they were offered occasional, undeclared jobs, such as to provide help in other households (cleaning, babysitting or taking care of elderly people), or to work in undeclared domestic activities or in private companies as undeclared labour. This puts them in very bad position because they do not enjoy any form of protection in the labour market. This also means that social and health insurance contributions are not paid for them, they cannot get days off or sick leave, their years of service are not registered, which reduces the possibility that they will receive an adequate income in old age.

The report prepared by the Union of Employers of Montenegro late in 2014, *The Informal Economy in Montenegro - Creating an Environment for Sustainable Development of Companies in Montenegro*, is one of the recent reports that provide an overview of the issue of the informal economy. The document identifies the key causes of the widespread informal economy as: an insufficient level of the rule of law; an inadequate regulatory framework; inflexible labour legislation; the high burden of taxes and contributions on salaries; high and numerous taxes at the level of local government; and a lack of available funds.⁴⁴

44 Union of Employers of Montenegro, (2011), *The Informal Economy in Montenegro - Creating an Environment for Sustainable Development of Companies in Montenegro*, pp. 12–16.

CHAPTER 2: PROFILE OF THE INFORMAL SECTOR IN MONTENEGRO IN 2014

“When informal employment was first recognised in the 1970s, the discussion focused on a small set of low-income countries. Inefficient public institutions, cumbersome registration processes and a general distrust of the government – all factors that spur the creation of a market outside a country’s formal structures – were seen as the epitome of under-development. Furthermore, it was assumed that these factors – and hence informal employment – would disappear in the course of economic development. The reality today looks different. Informality is increasingly becoming normal, not least in middle and even high-income countries.”⁴⁵

2.1. The Informal Economy in Montenegro in 2014 - Key Findings

The survey in the general population about working conditions conducted by IPSOS for the Ministry of Labour and Social Welfare (Informal Employment and the Grey Economy in Montenegro 2014, hereinafter referred to as: the Survey)⁴⁶, under the auspices of UNDP, was designed in such a way as to cover informal employment in the informal economy in line with the principles established at the 17th International Congress of Labour Statisticians. Thus, informal employment in the Survey includes: (a) employers, self-employed people and people employed for a salary in unregistered companies; (b) employees that work in registered companies without any contract, and employees with a contract but with only partially paid contributions. The Survey deviates from ILO principles in certain aspects related to employment status and the status of economic entities. The difference stems primarily from the inclusion of employed people whose salaries are only partially declared and from different a treatment of informality in terms of access to the social security system, paid leave and informal economic units in line with the 15th Conference of Labour Statisticians regarding registration and accountancy records.⁴⁷

The Survey was carried out on a sample of 1,038 households. Basic data about households was collected from the heads of the households, as well as basic data about all the household members (their relation to the head of the household, gender, age and education for a total of 3,538 household members). Additional data on work activities and other relevant things was collected from each household member

45 OECD (2009) – “Is Informal Normal? – Towards More and Better Jobs in Developing Countries”, p.11.

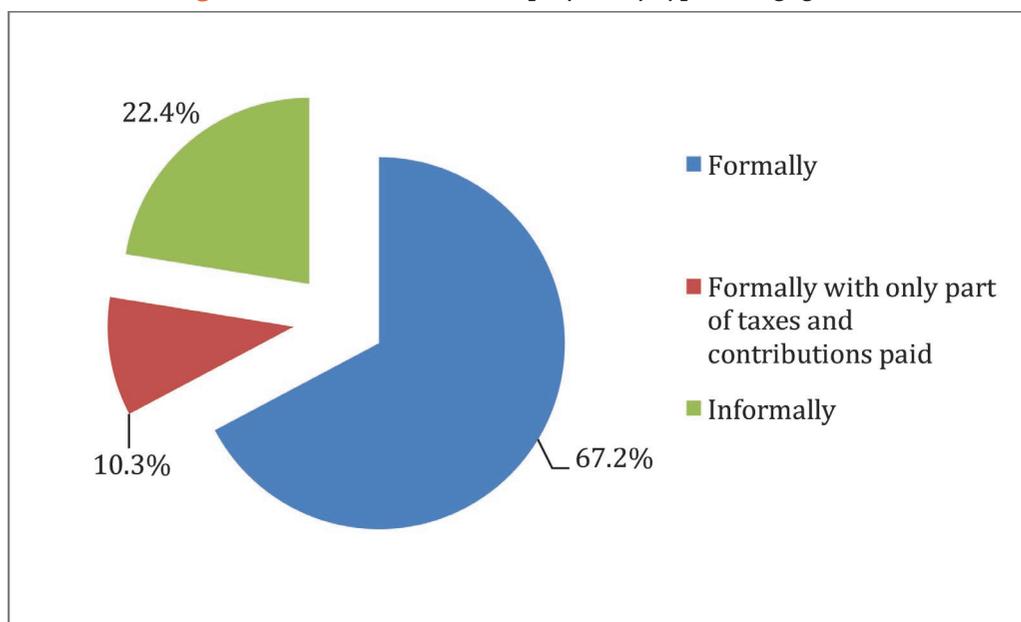
46 The Survey was conducted in November 2014 on a sample of 1,038 households and 409 companies and entrepreneurs.

47 ILO, (2013) – Measuring Informality: A statistical manual on the informal sector and informal employment, <http://unstats.un.org/unsd/EconStatKB/Attachment563.aspx>.

older than 15 (3,020 respondents).⁴⁸ Each household member older than 15 that had a job, or was active in the previous week was given a questionnaire on the conditions of work, i.e. employment, status, incomes, etc. (1,273 respondents). We need to take into account that the IPSOS Survey was conducted in November 2014 and hence, although on average it underestimates the number of people engaged in the informal economy, particularly in the sectors of agriculture and tourism due to the seasonality of work in these sectors, it has the effect of distorting the character of informal work in terms of most of its characteristics (Arandarenko & Simović, 2015).

According to the data from the Survey, 29.2% of the population of working age (15+) worked in the formal economy, while about half as many people worked in the informal economy, i.e. 14.2%.

Figure 2.1.1 - Structure of employees by type of engagement



Source: IPSOS (2014), (Informal Employment and the Grey Economy in Montenegro, 2014)

According to IPSOS's estimates, the budget of Montenegro had €140.6 million less revenue on an annual level because of avoidance of paying the appropriate taxes and contributions for informally employed workers. That is 9.4% of the total budget revenue.⁴⁹ Since the bulk of the revenue generated

48 The demographic characteristics of citizens older than 15 are as follows: gender (49.1% men and 50.1% women); age (17.9% of people are in the age group 15–24; 11.2% in the age group 25–30; 25.1% in the age group 31–45; 30.6% in the age group 46–64; and 15.1% in the age group 65+); education (28.4% of people completed primary or lower education, 53.8% secondary education, and 17.8% higher education); nationality (47.5% Montenegrins, 28.2% Serbs, 7.2% Muslims, 5% Albanians, 4.8% Bosniaks, 1.8% of other nationalities and 5.5% respondents who refused to answer this question).

49 IPSOS (2014), Informal Employment and the Grey Economy in Montenegro, p. 4.

in the informal sector is partially spent in the formal sector, the revenues lost due to the existence of informal labour amount to some €40.7 million lower.⁵⁰ Additionally, given the fact that it is not possible to formalize all the jobs that exist in the informal economy, and that formalization would mean lower incomes for those individuals hired in the informal economy, the real effect on the budget would be significantly lower.

However, the key problem of undeclared work is not the loss of revenues for the central budget, although this is an important issue. The key problem, particularly from the aspect of human development, is the quality of jobs for individuals – the possibilities for development of both individuals and businesses, the strengthening of competition and improvement of the standard and quality of life of individuals. Informally employed people and informal companies have skills and potential that can “flourish” in different circumstances with the implementation of effective strategies, while the informal economy can be an “incubator for business potential and an opportunity to acquire skills at work”.⁵¹

In addition to undeclared employment and salaries generated in the informal sector, companies also have surpluses that are not declared. Using the revenue method for calculation of GDP (as some South-East European countries do, since this data does not exist for Montenegro) and the data of companies on the undeclared salaries of employees and the undeclared profit of companies, IPSOS has estimated⁵² that salaries constitute 62.1% of the total revenues from the informal economy, while undeclared business surpluses make up 37.9%. The calculation made using these inputs and data about total salaries in the informal sector shows that the entire informal economy in Montenegro constituted 24.5% of GDP.

The data about the size of the informal economy in Montenegro in 2014 is not particularly surprising if we take into account the historical context and the results of the research carried out and published so far. At the same time, this high level of the grey economy in Montenegro can be made comparable if we put the data into the global context and compare with the one-third of global GDP that is generated in the informal sphere. Observed by region, the highest level of the grey economy (40%) was recorded in Latin America and Sub-Saharan Africa. This is followed by the average of 39% in Europe and Central Asia.

50 If €140.6 million is the amount of the revenues that were not collected in form of taxes and contributions, then the tax base, i.e. the total gross salaries in the informal sector, is at a level of €350 million. The assumption is that 70% of this amount will be spent in the formal sector and that 25% of revenues will be spent on products and services taxed at a lower VAT rate, while the remaining 75% will be spent on goods and services that are taxed at a higher rate.

51 ILO 2002 Resolution, p. 25.

52 IPSOS (2014), Informal Employment and the Grey Economy in Montenegro.

Table 2.1.1 - The informal economy in the EU (2012)

	% GDP		% GDP		% GDP
Austria	7.6	Spain	19.2	Sweden	14.3
Luxembourg	8.2	Portugal	19.4	Slovakia	15.5
Netherlands	9.5	Italy	21.6	Czech Republic	16
UK	10.1	Hungary	22.5	Belgium	16.8
France	10.8	Slovenia	23.6	Latvia	26.1
Ireland	12.7	Greece	24	Estonia	28.2
Germany	13.3	Poland	24.4	Lithuania	28.5
Finland	13.3	Malta	25.3	Romania	29.1
Denmark	13.4	Cyprus	25.6	Bulgaria	31.9

Source: Tackling Undeclared Work in European Union Member Countries and Norway, 2013.

The average size of the informal economy as a proportion of GDP in the European Union in 2012 amounted to 18.4% of GDP, where the level of the informal economy was lowest in Austria (7.6%) and highest in Bulgaria (31.9%).

Updated data on the number of people informally employed in European countries is not available since it does not form part of the official statistics. Germany's Institute for the Study of Labour made an assessment for 2009 on the basis of the Labour Force Survey (Table 2.1.2).

Table 2.1.2 - The informal economy in Europe (2009)

	% informally employed
Southern Europe	28.1
Western Europe	17.5
Eastern Europe	17.6
Northern Europe	11.8
Total	19.2

Source: Informal Workers Across Europe: Evidence from 30 Countries, 2011

Data shows that informal employment is a significant problem in all parts of Europe and that on average 19.2% of all employees in the 30 observed countries in Europe are informally employed. Recent research (Schneider, Buehn, Montenegro, 2010) has also shown that the informal economy is a global phenomenon and that the motives for participation in the informal economy are still insufficiently explained, as well as that both underdeveloped and developing economies face the challenge of the need to integrate the informal economy into formal flows.

2.2. The Scale and Characteristics of Informal Employment in Montenegro in 2014

“Unfortunately, a large number of young and elderly people do not have any other way to find a job, so they accept anything. They are forced to work for the minimum wage. There is exploitation, there are many different practices...” An informally employed woman who is paid her entire salary “cash-in-hand”.

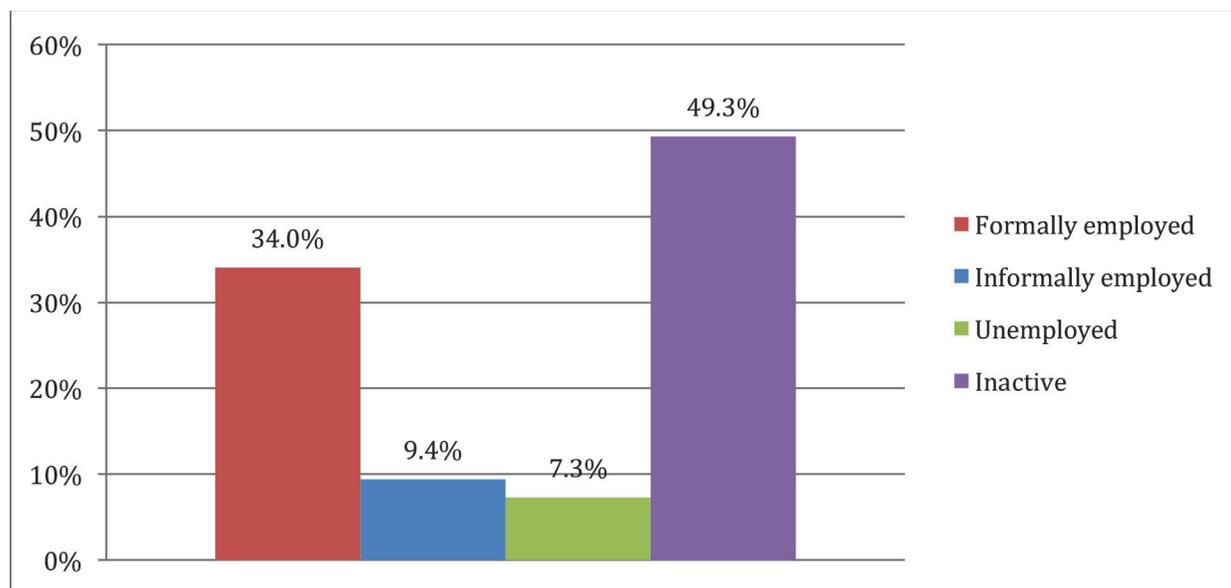
“Inspections do not do their jobs well. But, you know, we live in such times that it wouldn't be good if they did – if everyone had to declare all his/her employees, we would lose even these jobs that we have now. That is the situation.” An informally employed woman who is paid her entire salary “cash-in-hand”.

According to the Survey, in 2014 Montenegro had a total number of 70,418 undeclared employed people and people employed with partially declared earnings. This was 32.7% of the total number of people employed. Of this number 46,452 employed people or 22.3% of all the employees in Montenegro were undeclared and were earning incomes that were not formally recorded, i.e. they were receiving their salaries in cash without any payment of the appropriate taxes and contributions. The remaining 10.3% of the total number of employees, or 23,966 employees, had partially registered salaries, i.e. taxes and contributions were paid only on a part of their salaries (usually on the minimum wage for their particular education level), while they received the rest in cash without the payment of taxes and contributions. This further means that for one in ten people of working age in Montenegro who in the surveyed week did some activity for money, the appropriate taxes and contributions were paid only on a part of their salaries (10.4%). One in five people of working age (22.3%) was undeclared as employed and worked without any contract and without any taxes or contributions being paid for them.

The opinion of citizens does not significantly deviate from the Survey results. According to the opinions expressed in the Survey⁵³, citizens believe that the level of informally employed people in Montenegro is 31.4%, where 21.4% are those whose salaries are paid in cash without any payment of contributions, while 10.0% are those who have only part of the appropriate taxes and contributions on their salaries paid.

⁵³ In answer to the question: What, in your opinion, is the percentage of informal employment?

Figure 2.2.1 - Structure of the population above 15 and form of employment



Source : IPSOS (2014), Informal Employment and the Grey Economy in Montenegro, 2014

If we observe the structure of those formally employed, we can see that 85.8% are entirely in the formal sector, while 14.2% are in the group of people formally employed whose employers pay the appropriate taxes and contributions only on a certain portion of their salaries.

Table 2.2.1 - Structure of employees by status

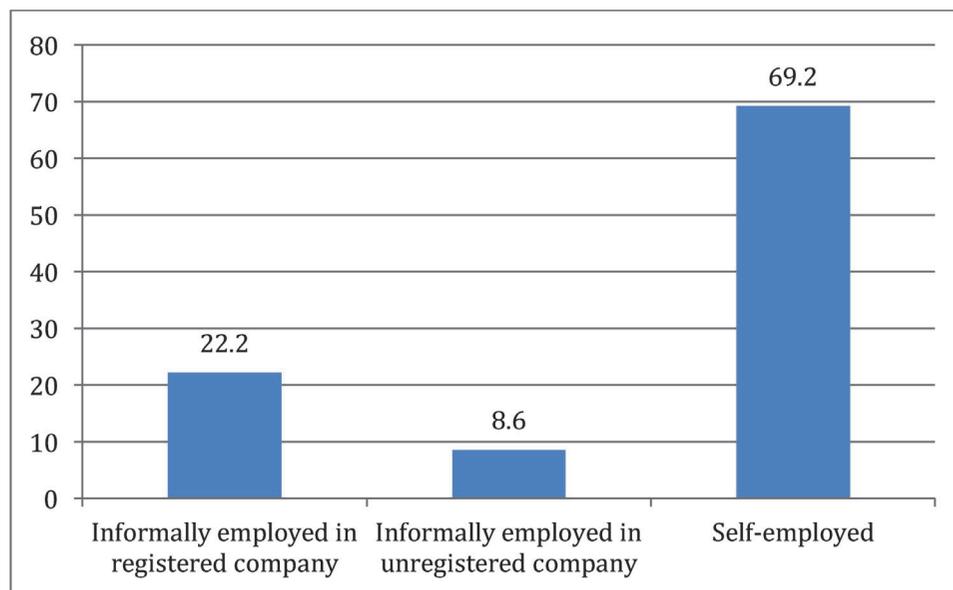
Structure	%
Total employees	100.0%
Formally employed	77.7%
Formally employed with their full salary declared	67.3%
Formally employed with part of their salary declared	10.4%
Informally employed	22.3%
Informally employed in a registered company	5.0%
Informally employed in an unregistered company	1.8%
Self-employed	15.5%

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

Comparison of this data with the result of the survey conducted by the Employment Office in 2007 shows a decline in the level of formally employed people who have part of their salaries undeclared. In

2007, 17.5% of declared employees (or 29,604 people) were in the category of employees, a part of whose salary was not declared⁵⁴. By 2015 this had reduced by approximately 3pp or nominally by approximately 5,000 employees.⁵⁵

Figure 2.2.2 - Structure of informally employed people



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

In the structure of undeclared employed people, the level of those self-employed is 70%, which possibly indicates the reasons for their engagement in the grey economy. On one hand, a high proportion of self-employed people in the group of undeclared employed people shows that individuals themselves opt to be engaged in the informal economy. This situation can also be an indicator of the lack of work places in the economy and of the fact that legislation regulating the business field is rigid and the tax burden on labour costs high.

2.3. The Face(s) of Informal Labour

Findings of the Survey about the features of employed people engaged in the informal sector in Montenegro do not differ significantly from those for other European countries. Analysis of the data from the Eurobarometer survey from 2013 shows that engagement in the informal economy is higher

54 ISSP/ZZZCG (2007), The Labour Force and Unemployment in Montenegro, July 2007 (<http://www.zzzcg.org/shared/dokumenti/Izvjestaji/Radna%20snaga%20i%20zaposlenost%20Final%20-%20RATKO%20BAKRA%C2%AC.pdf>).

55 Although these two surveys are not fully comparable, the part that refers to declaration of salaries is included in the survey in a similar way and therefore this comparison should be understood with this in mind.

among men than among women, while the percentage of engagement in the informal economy among citizens in urban areas is not much different from that in rural zones. Similar conclusions can be made on the basis of the Survey's findings.

The probability of engagement in the grey economy is higher for young people, less educated individuals, elderly and single or divorced people, as well as those that have more than one child and struggle to pay the bills every month.

In spite of the fact that the largest number of informally employed persons are those aged between 35 and 64 (59.9%), the rate of informal employment is highest among young people (34% for the age group 15-24) and the oldest (73% for persons aged 65+). Additionally, if we consider only formally employed people with partially paid taxes and contributions, we can see that the highest amount of these employees (19%) are in the group of young people, i.e. aged 15-24. This situation is similar to the situation in neighbouring Serbia (Koettl, 2013) and EU countries (William, Horodonic, 2015).

Table 2.3.1 - Structure of employees by engagement in the informal economy (% of the total number of employees in a certain age group)

Age	Formally employed	Formally employed with only part of their taxes and contributions paid	Informally employed	Total
15-24	48%	19%	34%	100%
25-30	72%	12%	17%	100%
31-45	71%	11%	17%	100%
46-64	67%	8%	25%	100%
65+	24%	2%	73%	100%
Total	67.3%	10.4%	22.3%	100%

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

In spite of the fact that people who retire due to old age have the right to work without having their right to a pension suspended, which is not the case with recipients of a family pension (except for pupils/students that receive a family pension), there are still a large number of retired people that are active in the informal economy.⁵⁶ One of the reasons for this situation might lie in the fact that a significant percentage of retired people are active in the sector of agriculture. Regardless of the sector where they are engaged, retired people are probably not motivated to pay additional taxes and contributions, since these would not have any significant influence on the scope of their pension rights or the amount of their pension. In addition to this, they already have health insurance secured. Thus, payment of

⁵⁶ Amendments to the Law on Pension and Disability Insurance from 2010 define that students and pupils who receive a family pension have the right to be formally employed and to continue receiving the family pension until the end of their schooling.

contributions and taxes for retired people would in most cases be a cost that does not result in any rights or any increases in benefits later in life.

Table 2.3.2 - Employed people by status and education level

Education level	Formally employed	Formally employed with only part of their taxes and contributions paid	Informally employed	Total
Without primary school	23.1%	6.0%	70.9%	100.0%
Primary school	43.3%	6.4%	50.4%	100.0%
Secondary school	66.0%	11.2%	22.8%	100.0%
High school	76.7%	15.4%	7.9%	100.0%
University	86.2%	8.6%	5.2%	100.0%

Source: IPSOS (2014), *Informal Employment and the Grey Economy in Montenegro 2014*.

The level of education is an important factor that determines a person's status in the labour market. In the group of employed people without primary school education, the largest proportion, as many as 70.9%, are engaged in the informal sector. For employed people with primary school education the probability that they are engaged in the informal sector is also high. The higher the education level, the larger the percentage of formally employed people (i.e. the lower the percentage of informally employed people).

The data is not so linear for formally employed people that receive part of their salary without payment of taxes and contributions to the state. The largest percentage in this group are people with upper-secondary and higher school education, 11.2% and 15.4% respectively. The percentage declines for people with a university degree (8.6%). In the group of formally employed people with partially paid liabilities to the state, the smallest number of people is constituted by those are educated only up to primary school level. The reasons for this might lie in their lower salaries that are close to the legal minimum or in the fact that most of them are informally hired.

Approximately two-thirds (63.6%) of informally employed people perform their activities outside of a company, e.g. in agricultural holdings, at home, in the form of "door-to-door" sales, in a vehicle, on the street, at an open market or in some other non-typical place, while this percentage is much lower for formally employed people (12.8%). Informal employment is characteristic for micro-sized companies (less than 10 employees) since 80.8% of informally employed people work in such companies.

Table 2.3.3 - Structure of employees by activity

Activity	Formally employed	Formally employed with only part of their taxes and contributions paid	Informally employed
1. Agriculture, forestry and fisheries	9.4%	3.5%	87.1%
2. Mining	83.6%	11.0%	5.3%
3. Processing industry	52.3%	26.5%	21.1%
4. Electricity, gas, vapour and air-conditioning supply	84.0%	5.6%	10.4%
5. Water supply, waste water management	94.9%	0.0%	5.1%
6. Construction industry	50.8%	12.8%	36.3%
7. Wholesale and retail, motor vehicle repairs	75.9%	9.9%	14.2%
8. Transportation and storage	76.9%	13.6%	9.5%
9. Services of accommodation and nutrition	60.6%	23.3%	16.1%
10. Information and communication	74.6%	3.5%	21.9%
11. Financial activities and insurance activities	92.1%	7.9%	0.0%
13. Expert, science, innovation and technical activities	60.1%	28.5%	11.3%
14. Administrative and ancillary services	93.3%	5.7%	1.0%
15. State administration and defence, compulsory social insurance	93.4%	6.6%	0.0%
16. Education	90.2%	6.4%	3.4%
17. Health and social care	98.1%	1.4%	0.5%
18. Arts, entertainment and recreation	49.7%	32.6%	17.7%
19. Other services	55.4%	9.7%	34.9%
20. Activities of households that function as employers	5.3%	3.8%	90.9%
21. Activities of extra-territorial organizations and bodies	65.6%	34.4%	0.0%
Total	67.2%	10.4%	22.3%

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014

Observed by activity, the largest volume of informal employment was recorded in agriculture and in households as employers - 87.1% and 90.9% respectively were informally employed out of the total number of people employed in the sector. The explanation for this situation in agriculture lies in the fact that an usually large number of unpaid family workers are engaged in this sector, as well as the fact that, in Montenegro, activities in this sector are mostly carried out in small family households and farms.

A large proportion of informally employed people out of the total number of those employed are recorded in the construction industry (36.3%) and services (34.9%). The largest level of evasion, i.e. paying taxes and contributions on a part of salaries only, was recorded in arts, recreation, and entertainment (32.6%), the processing industry (26.5%) and expert, research, innovations and technical activities (28.5%).

Since unregistered self-employed people make up almost 70% of the total number of undeclared employed people, their age structure has a slightly different profile than the total population of informally employed people. In this population the dominant group is made up of employed people age 46-64. Given their age structure, there is a high probability that these employed people are at the same time recipients of unemployment benefits and other rights. Hence, it is not profitable for them to formalize their status.

Table 2.3.4 - Structure of undeclared self-employed people by age

Age groups	% of self-employed people
15-24	7.2
25-30	8.8
31-45	29.5
46-64	42.4
65+	12.1

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

Analysis of the structure of self-employed people by education shows that 37% are people without any education or with only primary school education, while 6% have a university degree. Analysis of the data on employment by activity shows that the largest number of self-employed people are engaged in agriculture and services. Undeclared self-employed people make up a dominant proportion of the undeclared labour in agriculture, processing industries, in the sector of households that function as employers and in education.

Table 2.3.5 - Structure of undeclared self-employed people by education

Education	% of self-employed people
Without primary school	15.7
Primary school	21.3
Secondary school	55.4
High school	1.6
University	6.0

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014

By observing the structure of people informally self-employed by activity, their proportion out of the total number of people employed and their proportion out of the total number of people informally employed, we can get a more detailed insight into the profile of the informal sector and the character of informalities. Of the total number of people informally self-employed, 45.7% are engaged in agriculture, usually in small family households. A significant number of people who are informally self-employed are engaged in other services (16.5%) and within households that function as employers.

Informally self-employed people make up 81.4% of the total number of people employed in agriculture and 88.1% of the total number of people employed within households that function as employers. Informally employed people make up 22.7% of the total number of people employed in the construction industry, 19.6% of people employed in the processing industry, and 14.8% of the total number of people employed in other services.

Analysis of the structure of informal employment by activity and type of engagement shows that informally self-employed people make up 100% of all the people informally self-employed in mining, water supply and waste water management (probably plumbers) and in education (private lessons).

2.4. The Informal Economy - Gender Aspect⁵⁷

“In job interviews they ask you how old you are, if you have children and how old they are.” – An informally employed woman who is paid her entire salary “cash-in-hand”.

“I was asked if I was married, if I had any children, and some went so far as to ask me if I had a boyfriend. Because, if you have a serious relationship that might mean you will marry soon and have children.” – An informally employed woman who is paid a part of her salary “cash-in-hand”.

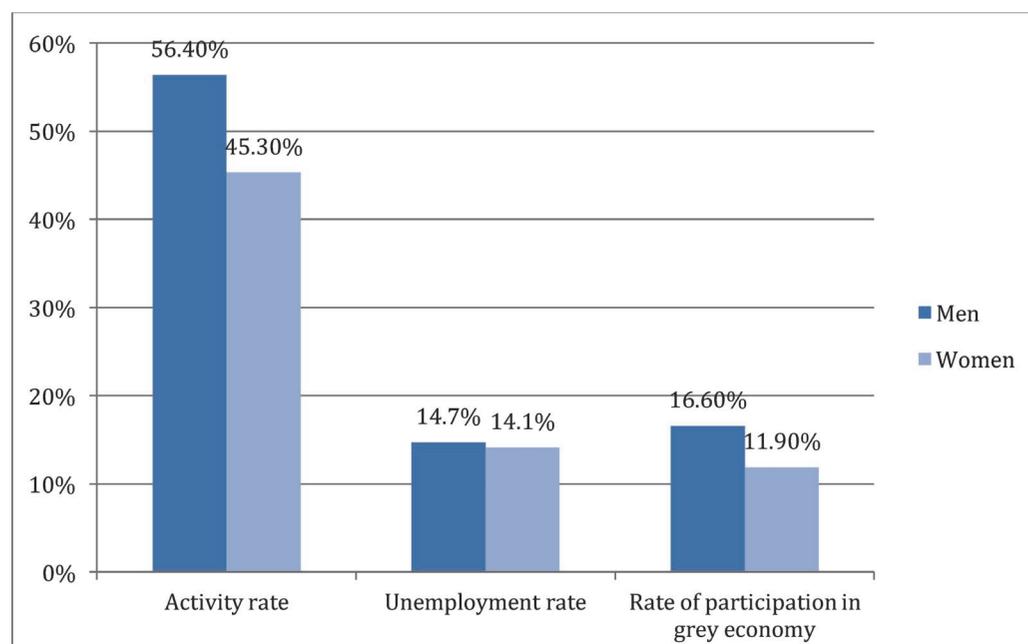
According to demographic characteristics, women are less engaged in informal activities than men, which is the case in transition countries (Lehmann and Pignatti, 2007; Bernabè and Stampini, 2008), but not in developing countries (Perry et al., 2007). Lower rates of informal employment of women than men in Montenegro are in line with the findings of Angel-Urdinola and Tanabe (2012), which show that higher informal activity of women can be found in countries where the proportion of people employed in agriculture out of total employment is significant, since women dominate as unpaid household members who help the other members. In Montenegro, the level of people employed in agriculture out of the overall employment is relatively low (6.2%).

To assess the net impact of factors like education, location, activity, etc. on the decision of individuals to be informally employed, we used regression analysis. We analysed the factors that influence informal

⁵⁷ IPSOS (2014), Informal Employment and Grey Economy in Montenegro 2014

employment and identification of which could be of use in defining policies aimed at reducing informal employment. That analysis showed that gender is not a significant determinant of informal employment if we assume that the other characteristics of the individual are the same. Descriptive analysis yielded different results. Other insignificant variables include whether the person receives social benefits and the marital status of the person, although more recent research shows that good and stable employment is an important precondition for young people, particularly men, entering into marriage (Angel-Urdinola and Tanabe 2012).

Figure 2.4.1 - Key labour market indicators by gender



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

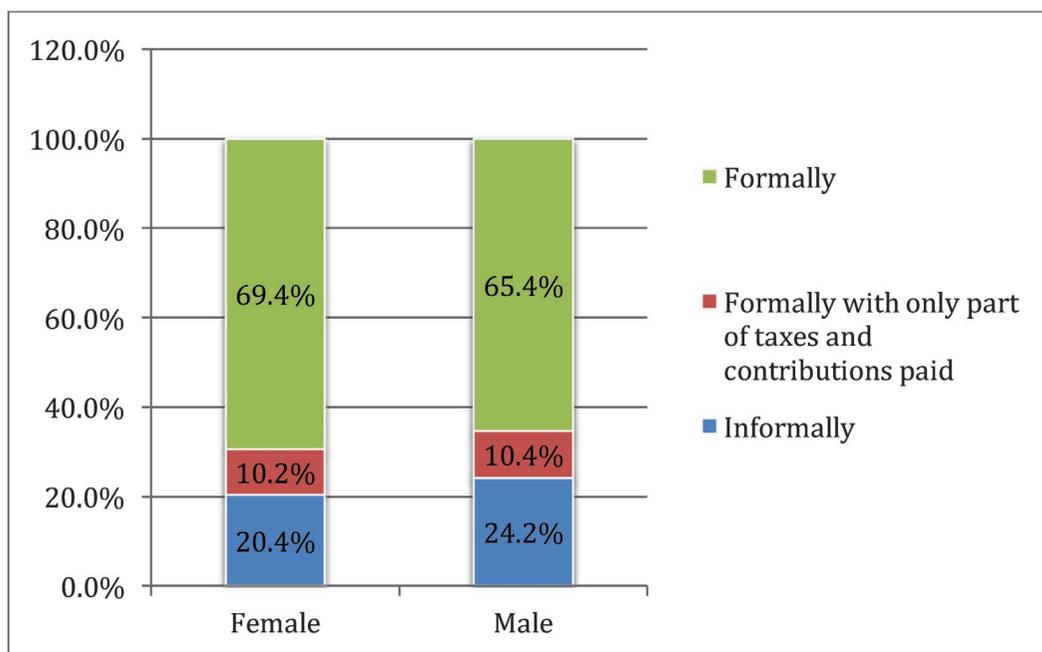
The survey has shown that women are less engaged in informal activities than men.⁵⁸ Also, the activity rate of women is lower than the activity rate of men, and the same goes for the unemployment rate. Of the total number of employed women, one in five is engaged within the informal sector, while for men, one in four is informally employed. Close to 70% of women are formally employed while about 65% of men are formally employed.

Observed by gender, it is clear that within the group of formally employed, men and women are equally represented (52.3% and 47.7% respectively), although the slightly lower share of women can be explained

⁵⁸ IPSOS (2014) – Informal Employment and the Grey Economy in Montenegro.

by a lower general rate of activity for women. Within the group of people formally employed but with a partially declared salary, the proportions of men and women are similar to those of people formally employed with the entire salary declared. As for those employed in the informal sector, women are better represented in the group of those who are informally self-employed (44.8%), while the proportion of women is lowest in the group of people informally employed in unregistered enterprises.

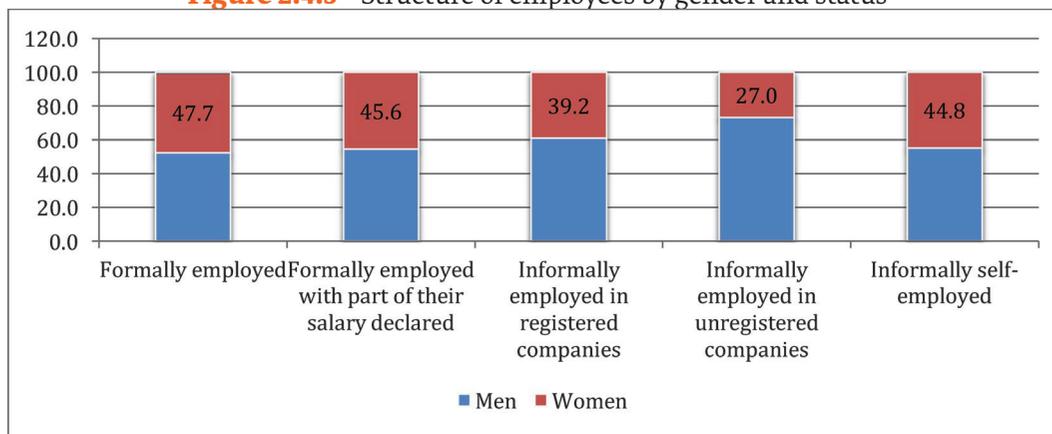
Figure 2.4.2 - Structure of employees by gender and status



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

If we analyse the attitudes of the working population towards the spread of informal employment, we can notice that women give more optimistic estimates of the share of workers for whom the taxes and contributions on salaries are duly paid. Thus, women think that out of the total number of people employed in companies/organizations/institutions in the same field of activities that they work in, full taxes and contributions are paid for 72% of employees. Men estimate this share to be 66%. On the other hand, women think that for 8% of employees only part of the taxes and contributions are paid, while men say that this share is 11%.

Figure 2.4.3 - Structure of employees by gender and status



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

2.5. Inclination towards the Grey Economy - Enterprises and Entrepreneurs

According to the results of the IPSOS survey on the conditions of business operations of enterprises and entrepreneurs in Montenegro in 2014, 38.4% of economic entities in Montenegro conducted activities in the grey economy.⁵⁹ Analysis of the forms of the informal economy shows that slightly more than one-third of economic entities informally employed workers (34.2%), while 17.4% of VAT payers made more than 10% of their payments in cash.⁶⁰

Conclusions from the research show that legal entities are more inclined to be involved in activities in the informal economy than registered entrepreneurs (38.7% compared to 36.8% respectively). Enterprises established in 2009 or later are more inclined to undertake activities in the grey economy than enterprises established before 2009 (42.4% vs. 34.7% respectively). These findings may indicate that enterprises established after 2009 faced more difficult conditions for business operations after the outbreak of the global crisis, and partly also that, as they grow and develop, companies increasingly operate within the formal economy. The cause of this difference may partly lie in the fact that in large industries and enterprises established several decades ago (EPCG, Telekom, commercial banks, etc.) most employees are formally employed.

Informal activity is more present in small enterprises with 10-49 employed people (42.1%) and it is precisely this category of companies that hires the largest proportion of undeclared employed people (39.8%) and makes up the highest percentage of undeclared turnover (27.5%). Among micro-sized enterprises with 0-9 employees, there is a slightly lower rate of informal activities (38.5%), while this rate is lowest among medium-sized and large enterprises with 50+ employees (11.1%).

⁵⁹ IPSOS (2014), Informal Employment and the Grey Economy in Montenegro

⁶⁰ The research was conducted in such a way that the representatives of the business sector in Montenegro (economic entities and entrepreneurs) answered indirect questions with a view to providing estimates of the grey economy in other companies.

Table 2.5.1 - The percentage of economic entities in the private sector (EEPS) that are engaged in the grey economy by characteristic

	% EEPS engaged in grey economy	% EEPS with informally employed people	% VAT payers with more than 10% cash payments	% EEPS that have both forms of the informal economy
Total	38.4	34.2	17.4	13.3
Type of economic entity				
Company	38.7	34.1	19.3	14.7
Entrepreneur	36.8	35.0	7.0	5.2
Year the enterprise was established				
Before 2009	34.7	29.9	18.2	13.4
2009 or later	42.4	39.0	17.6	14.2
Number of employees				
Micro (0-9)	38.5	33.8	14.9	10.2
Small (10-49)	42.1	39.8	27.5	25.3
Medium or large (50+)	11.1	6.3	7.9	3.2
Activity				
Other services	45.8	43.4	19.0	16.7
Tourism	31.4	31.4	13.3	13.3
Agriculture	51.1	44.7	17.0	10.6
Construction industry	38.5	35.9	27.8	25.1
Trade	36.8	31.4	14.9	9.4
Industry	26.9	16.5	17.4	7.0
Region				
Northern	26.6	26.6	8.1	8.1
Central	42.5	36.2	19.0	12.7
Southern	38.5	35.1	19.3	15.8

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

Observed by activity, the largest percentage of economic entities that are engaged in activities of the informal economy operate in the field of agriculture (51.1%), the sector of other services (45.8%) and the construction industry (38.5%). The data for agriculture is not surprising because of the existence of many small agricultural holdings/enterprises. Thus, in agriculture the largest percentage of economic entities are enterprises with a small number of employed people, of which about a half are informally employed (44.7%), while the percentage of VAT payers that make more than 10% of their payments in cash is approximately average (17.0%).

In addition to agriculture, where a large volume of informal economic activity is expected, the sector of “other services” also has a high level of economic entities that are engaged in the grey economy. Approximately 43% of economic entities from the sector of “other services” have informally employed people, while 19% of VAT payers have undeclared incomes. Primarily services like financial mediation, property, renting and business activities, transportation, etc. demonstrate an above-average level of both forms of the informal economy in this sector.

The largest percentage of economic entities, VAT payers, that have undeclared incomes operate in the construction industry (27.8%). More than one-third of economic entities in the construction industry (35.9%) have informal employees. If we analyse the forms of informal employment individually, we find that the largest percentage of economic entities that hire workers either without a contract, or with a contract but without declaring the entire salary, operate in the field of construction (34.3% and 21.8% respectively). Construction also has the largest percentage of economic entities that at the same time have two forms of informal employees (20.2%).

Observed by region, economic entities with their headquarters in the central region are most inclined to do activities in the grey economy, and those in the north are least inclined to operate in such a way (42.5% to 26.6%). A similar distribution can also be seen in individual forms of the informal economy. Economic entities in Podgorica are dominant as far as informal employment is concerned, and they also dominate where “turnover” in the grey economy is concerned, together with the southern region.

It has already been noted that one in three economic entities hires informal workers (34.2%). The most common form of informal employment is that whereby employees are paid part of their salaries in cash. A fifth of all economic entities use only this form of informal employment (20.5%). Hiring workers without a contract is significantly less frequent and only one in 20 enterprises uses only that form of informal employment (4.6%). In addition to this, one in 10 enterprises uses both of the above forms of informal employment (9.1%). Enterprises that pay appropriate taxes and contributions for at least some of their employees for at least a part of their salaries make up 29.6% of the total number, while 13.7% of enterprises hire at least some of their employees without a contract.

We can conclude that engagement in the grey economy may be motivated by the fact that as many as 80% of enterprises that hire employees informally have a pessimistic view of what the trends in

the Montenegrin economy will look like in the following year, particularly since legislation in the labour market is inflexible. Companies that have only formally employed people have a slightly more optimistic view of the economic prospects - one-third of these companies have positive expectations.

CHAPTER 3: **THE INFORMAL ECONOMY AND POVERTY, INEQUALITIES AND EXCLUSION**

“People are in such a situation that they have to do anything. In my company we get our salary every month and it is not so important that they do not pay taxes and contributions and that our salary is small.” – An informally employed woman who is paid part of her salary “cash-in-hand”.

“The uncertainty is huge... if you have a permanent job it is much better than this... today I have this job, but tomorrow – who knows...? I could lose it in a day. When you have a permanent job you try harder, although, I do try hard to do everything I am doing well, the best I can, and they are satisfied, everything is fine, but there is no security...” – An informally employed woman.

3.1. The Informal Economy and Poverty

Empirical research has shown that the informal economy, i.e. household income from undeclared work, constitutes a significant source of household income and that it leads to a reduction in the risk of poverty. Empirical data from the Survey shows that this is also the case in Montenegro.

The poverty rate and rate of poverty risk are calculated in the national statistics on the basis of the World Bank’s methodology and they are based on the spending of the population. The absolute poverty line is set using a method using the cost of basic needs that include food and non-food products and services, where the food items and the minimum quantity of products are estimated on the basis of the nutrition recommendations for the required calorie intake. According to MONSTAT data, the poverty rate, i.e. the proportion of people whose spending is below the national poverty line, ranged between 11.3% in 2006 and 8.6% in 2013.

Table 3.1.1 - Key poverty indicators

	National absolute poverty line (in € per month)	Poverty rate (%)	Poverty gap (%)	Poverty severity (%)	Gini coefficient (%)
2006	144.68	11.3	1.9	0.6	24.4
2007	150.76	8.0	1.4	0.4	26.4
2008	163.57	4.9	0.9	0.3	25.3
2009	169.13	6.8	1.4	0.5	26.4
2010	169.98	6.6	1.1	0.3	24.3
2011	175.25	9.3	2.0	0.7	25.9
2012	182.43	11.3	2.8	1.4	26.5
2013	186.45	8.6	2.4	1.1	26.2

Source: MONSTAT

The data for assessing the risk of poverty, particularly among informally employed people, comes from the Survey, based on Eurostat's methodology that assesses the poverty risk on the basis of equivalent income, unlike the expenditure-based methodology used by MONSTAT. The poverty risk rates obtained by these methodologies are not comparable.

According to the Survey, the poverty risk rate, which is defined as the proportion of the population whose equivalent income is lower than 60% of the median equivalent income of the overall population, based on the status in the labour market, shows that unemployed people are in the worst position, since almost a half of all unemployed people age 15 and above (47.6%) are exposed to the risk of poverty (Table 3.1.2.).⁶¹ This is significantly higher than the average poverty risk rate for the overall population age 15 and above, which amounts to 19.3%.⁶²

61 The equivalent income is calculated by weighting the household income with the number of household members. The first household member (head of the family) has a weighting factor of 1, for the second household member it is 0.7, other members older than 14 have a weighting factor of 0.5, while for children under 14 it is 0.3.

62 The poverty risk rate that IPSOS used in its survey was calculated according to the Eurostat methodology that is used in SILC research. Since the data used for assessment of the poverty risk rate was obtained from the survey of household incomes, they have to be treated with care, given the inclination of households to underestimate incomes.

Table 3.1.2 - Poverty risk rate according to status in the labour market after and before social transfers (population age 15+), %

	Poverty risk rate after social transfers	Poverty risk rate before social transfers	Reduction of the poverty risk rate after social transfers
Total population age 15+	19.3	20.1	-4.0
Total employed people	9.7	10.1	-4.0
Informally employed people	17.1	18.3	-6.6
Employees that work for employers	7.2	8.1	-11.7
Self-employed people	27.2	28.2	-3.5
Formally employed people	5.9	6.1	-2.1
Employees that work for employers	6.1	6.2	-2.1
Self-employed people	5.6	5.6	0
Unemployed people	47.6	48.1	-1.0
Inactive	24.1	25.2	-4.7

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

Data from the Survey also shows that employment significantly reduces the risk of poverty, but this does not mean that employed people cannot be poor, since poverty, among other things, also depends on the quality of employment, i.e. the amount of income from employment. In this sense an appropriate income is just one of the conditions for decent work and poverty reduction. According to the ILO, other factors include “opportunities for work that is productive... better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men.”⁶³

If we analyse the entire group of informally employed people, we can see that they have a significantly higher poverty risk rate than formally employed people (17.1% vs. 5.9% respectively). If we analyse the poverty risk of the groups within informally employed people and compare them to the formally employed people, employees who are undeclared and work for an employer face a slightly, but not significantly, higher risk of poverty than formally employed people (7.2% vs. 6.1% respectively). This to a certain extent distorts the established understanding that informally employed people are paid much worse than formally employed people. Also, if we assume that employers strive to keep labour costs at the same level, formalization of these jobs would increase the risk of poverty.

⁶³ <http://www.ilo.org/global/topics/decent-work/lang--en/index.htm>.

Differences in the poverty risk are particularly emphasized among informally self-employed people where 27.2% of them are exposed to the risk of poverty. This percentage is particularly high if we compare it to the risk of poverty of registered self-employed people. It amounts to 5.6%, which is lower even if we compare it to the risk of poverty of formally employed people. This data can also be explained by the fact that 35% of informally self-employed people are farmers, whose incomes in kind are not included in their income.

A very important aspect of engagement in the informal economy is also obtaining social transfers since they have an impact on the reduction of the poverty risk rate for various categories of people in the labour market. The effectiveness of social transfers measures the percentage by which social transfers reduce the poverty risk rate.⁶⁴ Social transfers are important also from the aspect of targeting, i.e. the question of whether they reach the people they are intended for. Social transfers (without old-age and family pensions) reduce the poverty risk rate of the population age 15+ in Montenegro by 4.0%. In other words, if there were no social transfers (excluding old-age and family pensions) the risk of poverty would be 20.1% instead of 19.3%.

The highest contribution of social transfers to the reduction of the poverty risk rate is recorded for informally employed people (6.6%), while for formally employed people the figure is 2.1% and for inactive and unemployed people it is 4.7% and 1% respectively. Within the group of informally employed people, the most significant benefits from social transfers were enjoyed by employees working for an employer, since their poverty risk rate was reduced by 11.7% (from 8.1% to 7.2%), while the effect on self-employed people, who are the most vulnerable, was relatively modest at 3.5% (IPSOS, 2014).

A particularly interesting set of data shows that a total of 3% of informally employed people are beneficiaries of material allowance for families. This means that one-quarter of the beneficiaries of material allowance for families who are able to work have a motive to stay in the informal sector, because as beneficiaries of this right they obtain a number of other benefits and privileges.

3.2. The Informal Economy and Inequality

A common concept of inequality compares the proportions of the spending or incomes of the population, divided into deciles or quintiles depending on the level of income. The Survey opens up the possibility of observing inequality in incomes. Observed at the level of all informally employed people, their average incomes are on average 28.7% lower than the incomes of formally employed individuals.⁶⁵

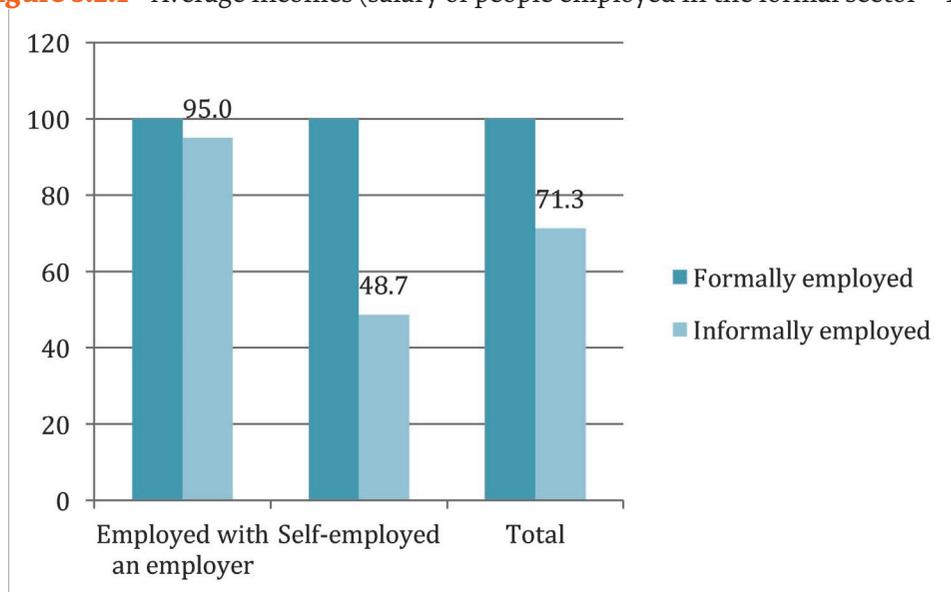
⁶⁴ Social transfers include material allowances for families, personal disability allowance, benefit for care and support, health care, funeral costs, one-time monetary support, allowance for newborn babies, child allowance, unemployment support, costs of nutrition in preschool institutions, support for upbringing and education of children and the young with special education needs, reimbursement of compensation of salaries and compensation of salaries for maternity leave, i.e. parental leave, allowance for the birth of a child, reimbursement of the compensation of salary and compensation of salary for working part time. Old-age and family pensions are not included.

⁶⁵ Source: IPSOS (2014) – Informal Employment and the Grey Economy in Montenegro 2014.

However, if we observe sub-groups, the Survey shows that people employed informally with an employer earn 5% less than formally employed people, while undeclared self-employed people earn approximately 51% less than registered self-employed people. The difference in the levels of formally and informally self-employed people is probably conditioned by the fact that the first group includes lawyers, notaries, accountants, etc. who are highly paid, while the second group includes mostly farmers.

In addition to this, if we compare the hourly salary, the difference in the amount is small, since informally employed people earn €2.50 per hour, while formally employed people earn €2.60 per hour of work.

Figure 3.2.1 - Average incomes (salary of people employed in the formal sector = 100)



Source: IPSOS (2014), Informal Employment and Grey Economy in Montenegro 2014.

The distribution of incomes into income deciles shows that there is a more significant inequality in incomes within the group of informally employed people.⁶⁶ The first decile (the 10% of informally employed people that earn the least) makes up 2% of the total income of informally employed people, while the tenth decile (the 10% of informally employed people that earn the most) makes up approximately 20% of the total income of informally employed people.

⁶⁶ Income deciles are obtained by ranking employed people by income from employment from the lowest to the highest and then splitting the list into 10 equal groups. Comparison by income deciles serves for the assessment of inequality in incomes, i.e. to show what the difference is between the earnings of the decile (10%) of employed people that earn the least and the decile (10%) of the best-paid employed people.

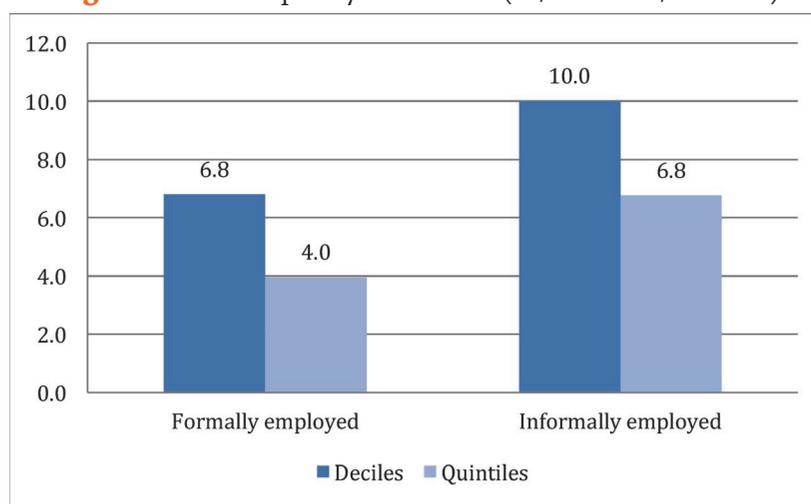
Table 3.2.1 - Distribution of employed people by share of income

Income deciles	Employees (total)	Informally employed	Formally employed
Decile (lowest 10%)	2.4%	2.0%	3.9%
Decile	4.8%	3.5%	5.4%
Decile	6.2%	4.7%	6.8%
Decile	7.8%	6.6%	7.4%
Decile	8.5%	8.6%	8.5%
Decile	9.8%	10.6%	9.5%
Decile	11.0%	12.1%	10.1%
Decile	12.3%	14.7%	11.3%
Decile	14.3%	17.7%	12.9%
Decile (the top 10%)	22.8%	19.6%	24.2%

Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

Within the group of formally employed people, the first decile or 10% of employed people with the lowest income makes up approximately 4% of the total income of formally employed people, while the tenth decile earns an income that is equal to one-quarter of the total income of the whole group. Inequality at the level of the overall group of employed people is slightly higher than at the level of the group of formally employed people, under the influence of higher inequality within the group of informally employed people. This can be seen on the basis of the 90/10 and 20/80 ratios (Figure 3.2.2), which shows that informally employed people in the tenth decile earn 10 times as much as those in the first decile, while this ratio in the group of formally employed people is 6.8.

Figure 3.2.2 - Inequality in incomes (90/10 and 80/20 ratios)



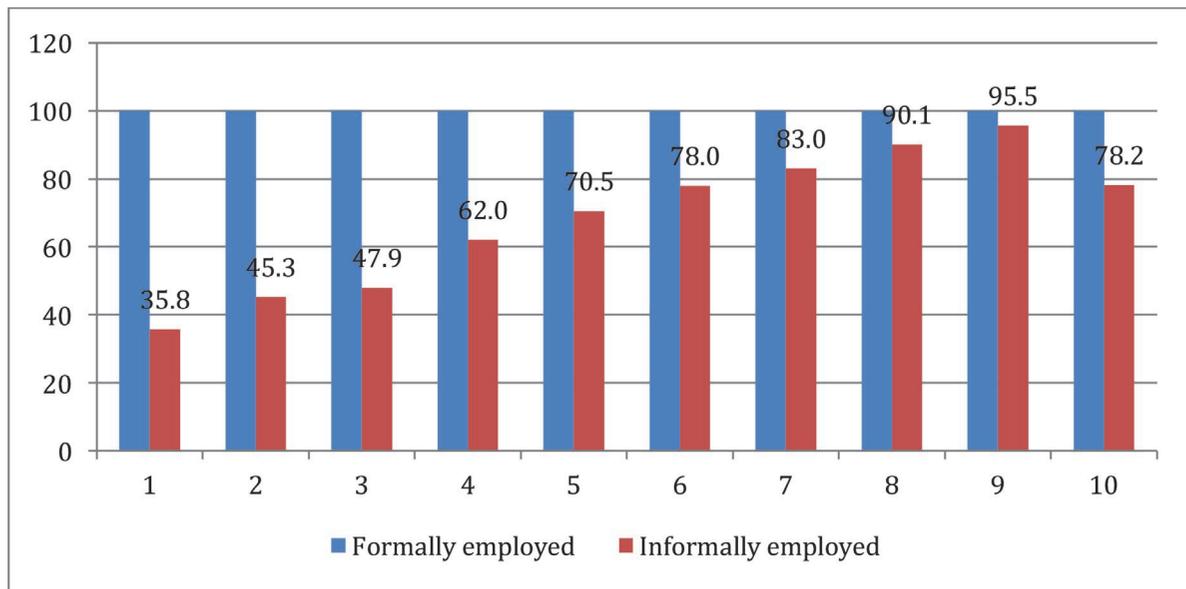
Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

If we observe the relation of income quintiles (employed people divided into five groups, 20% each according to the level of income) inequality declines within both groups by approximately one-third.

Data shows that the highest inequality by decile exists within the lower-income deciles, where the income of informally employed people in the first decile amounts to 35.8% of the income of formally employed people in the first decile. The difference decreases as we move to the higher deciles. The inequality is lowest within deciles 8 and 9 where the income of informally employed people amounts to over 90% of the incomes of formally employed people. This data shows that differences in incomes, i.e. inequality between formally and informally employed people are not significant, with the exception of the lowest deciles. Also, the income from informal employment is no higher than from formal employment, while if the existing jobs were formalized, the income of informally employed people (presuming that employers keep labour costs at the same level) would be 40-50% lower, which would increase the gap between these two groups.

On the basis of this analysis it can be concluded that the large gap in the lower-income deciles indicates the lack of protection by the minimum wage. However, since probably the lowest income deciles are made up of self-employed people working on their own farms with a total net salary that is lower than the minimum wage, the minimum wage would for them be too high a cost rather than a protection. This fact is even more obvious if we bear in mind that the average net income of informally self-employed people is at the level of the national net minimum wage.

Figure 3.2.3 - Income from employment by deciles (formally employed people = 100)



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

3.3. The Informal Economy and Social Exclusion/Marginalization and Human Rights

“How can I be happy if I do not have any insurance and I have no working hours.” – An informally employed woman whose entire salary is paid “cash-in-hand”.

“If I go on vacation or have to be absent from work, my colleague will have to work two shifts and then I will have to do the same when she goes on vacation.” – An informally employed woman who is paid part of her salary “cash-in-hand”.

One of the basic characteristics of engagement in the informal economy is the poorer quality of jobs both in terms of income and in terms of working conditions. Unsatisfactory working conditions, non-compliance and endangering of the rights that are guaranteed by the Constitution and the laws of Montenegro can pose a significant threat to fundamental human rights. The ILO's Recommendation No. 204 recognizes as a deficit of informal work the fact that there is “a lack of sufficient opportunities for high-quality employment, inadequate social care and a lack of social dialogue”. However, because this report, just like the research it is based on, does not deal with work that is outside the boundaries of activities permitted by legislation, and does not explore forms of work that are not decent, social exclusion and marginalization and human rights will be observed through the equality of all employed people before the law and through ensuring equal treatment at the workplace.

Social exclusion was defined for the first time in Montenegro in the National Human Development Report 2009: Montenegro – A Society for All. In order to be treated as socially excluded, an individual has to meet the requirements in these categories – income (the income per household member should be below 60% of the median income); labour (the individual is unemployed); and accessibility of social care (primarily health care). Since, according to this definition, one's status in the labour force, i.e. being employed or unemployed, is one of the disqualifying factors, it is clear that work engagement even in the informal economy has an impact on the reduction of the social exclusion of individuals. In this way, the informal economy has a positive impact on social exclusion: it reduces social exclusion. However, undeclared work or partially declared work causes the deprivation of individuals in terms of certain rights.

Work in the informal sector, particularly undeclared work within the formal or informal sector, regardless of whether it leads to a reduction in the risk of poverty and social exclusion, also leads to the deprivation of this category of employed people, particularly in terms of using social care services, primarily pensions and health insurance. Non-payment of the appropriate taxes and contributions, particularly if it is a long-term practice, can lead to an increased risk of poverty in old age, since shorter periods of payment of contributions lead to lower pensions later in life. Additionally, the lack of an adequate work history in the formal sector can lead to poorer prospects for employment in the future

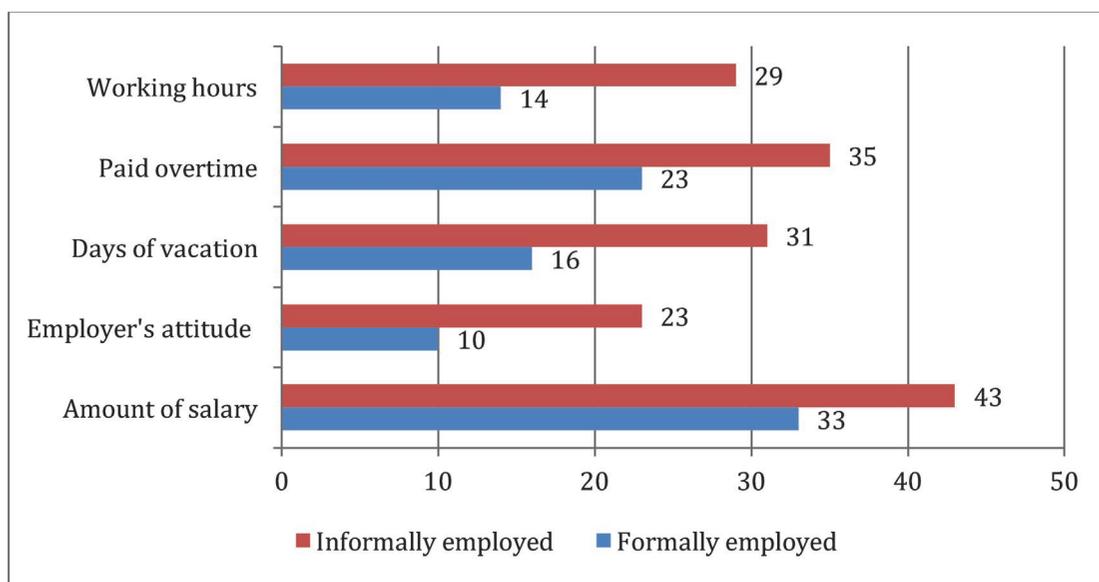
and reduces access to higher quality jobs for employees who spend a significant part of their working career in the informal sector. In 2014 in Montenegro, 19% of undeclared employed people worked in the same jobs for longer than 15 years. The average period in which people work without having contributions paid for the entire amount of their salaries amounts to 7.5 years, and for people who do not have any contributions paid this period is as long as 9.7 years.

Also, undeclared work is a form of work that does not ensure the fundamental rights guaranteed by labour legislation, like a notice period, severance pay, the possibility of obtaining compensation of unpaid salaries, the right to collective bargaining, severance payments, minimum wage, working hours, notices, vacations and other rights guaranteed in labour legislation. Thus, working in the informal sector becomes significantly more uncertain than declared work. Around 15% of employed people see mobbing as a danger specific to undeclared work. Mobbing is defined as an “unfair” attitude of employers towards employed people in their workplace and possibly discrimination.

The Survey showed that, as expected, the strongest dissatisfaction among both formally and informally employed people is related to salaries. Approximately one-third of formally employed people are unhappy with the level of their salaries, while one-quarter are unhappy with how their overtime is paid (33% and 23% respectively). The level of dissatisfaction is higher among informally employed people, since more than two-fifths of informally employed people are unhappy with the level of salaries and more than one-third with how their overtime is paid (43% and 23% respectively).

There is a large difference in the scope of rights between formally and informally employed people in paid vacation and working hours. Working hours are unsatisfactory for 29% of informally employed people. We should bear in mind, though, that the Survey showed that informally employed people work on average shorter working hours than formally employed people (35.7 vs. 41.8 hours respectively). As for paid vacation, 31% of informally employed people are unhappy with the length of their paid vacation, while 16% of formally employed people have the same opinion. In addition to this, informally employed people that have paid vacation used a significantly smaller number of days of vacation (17.7) than formally employed people (22.8), while the minimum stipulated in the law is 20 working days. It should be noted that the Survey included also employed people in the public sector who, as a rule, enjoy full rights to vacation, and if we were to exclude them from the sample, the data for formally and informally employed people in the private sector would not differ so much.

Figure 3.3.1 - Dissatisfaction with working conditions, % of the total number of employed⁶⁷



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

An additional difference between formally and informally employed people can be noticed regarding the weekly rest that, according to the law, has to be at least one day per week. Approximately one-third (30%) of undeclared employed people do not have any paid day-off during the week⁶⁸, while 14% of formally employed people on whose salaries taxes and contributions are partially paid do not have paid days-off during the week. Among formally employed people, 4% do not have days-off during the week. The Survey showed that all employed people would be happier with their jobs if some of their rights were respected, like the right to weekly or annual leave.⁶⁹

The key remarks of employed people in Montenegro can be reduced to the unsatisfactory quality of their jobs, and this does not only refer to the informal sector. However, although the situation is not dramatically different than in other countries, it is clear that there is significant room for improvement in terms of respect for the rights of informally employed people and in terms of the reduction of deprivation. This would in the long run contribute to an improvement in the standard of living and quality of life, i.e. it would lead to improvements in human development.

⁶⁷ The figure shows the percentage of employed people whose answered the question "Generally speaking, to what extent are you satisfied with the following conditions in your work place?" with: "dissatisfied" or "mostly dissatisfied".

⁶⁸ The high percentage of undeclared employed people who do not have any paid day-off in the week can be partly explained by the fact that, among the respondents, i.e. among informally employed people, there are a large number of self-employed people in agriculture that are, as a rule, engaged every day because of the nature of the work they do.

⁶⁹ IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014, p.60.

CHAPTER 4: THE CAUSES AND CONSEQUENCES OF THE INFORMAL ECONOMY

In various sources in the field of economics we can distinguish four broad conceptual explanations of the motives for participation in the informal economy (OECD 2009):

- The concept of dualism that sees the informal sector as marginalized activities aimed at survival, without any connection with the formal sector (Hart, 1973);
- The concept of structuralism (Moser 1978; Castells and Portes, 1989) that sees informal activities as activities subordinated to the formal sector and a way of reducing the costs of enterprises;
- The concept of legalism, present in the works of Hernando de Soto (1989, 2000), that emphasizes the role of excessive regulations or the costs of formal business operations which drive entrepreneurs to operate in the informal sector; and
- The concept of parasitism (Lewis, 2004) that sees informal activities as the means for achieving unfair advantages in relation to the competition that operates in the formal sector.

Starting from the explanation of the motives for taking part in the informal economy, empirical studies since the 1990s have identified the key determinants of the informal economy (for details see table below that can be put into four broad groups):

- Costs of formality - taxes and other burdens
- Quality of regulations and the business environment
- Informal institutions - tax morale
- Efficiency of the public sector in the provision of services - justification for taxation and sanctions

The key determinants of the informal economy⁷⁰

Cause	Theoretical explanation	References
Taxes and the tax burden of labour	The total tax burden influences the choice of work/leisure and can stimulate the labour supply in the informal sector. The higher the difference between the total labour costs in the formal economy and earnings after taxes and contributions are paid, the higher the incentive to reduce the tax burden and to work in the grey economy is.	Thomas (1992), Johnson, Kaufmann and Zoido-Lobaton (1998), Giles (1999), Tanzi (1999), Schneider (2003, 2005) et al.
Quality of institutions	Quality of institutions influences informality – particularly (in)efficient and discretionary application of tax legislation. It has a stronger impact than the level of burden. A certain level of taxes that is later spent on productive public services characterize efficient policies. The informal sector is developed as a consequence of the failures of institutions in the promotion of an efficient market economy.	Johnson et al. (1998), Friedman, Johnson, Kaufmann and Zoido-Lobaton (2000), Buehn and Schneider (2012), etc.
Regulations	Regulations, such as legislation in the labour market or trade barriers, constitute an important factor that reduces the freedom of choice for individuals in the formal economy. Regulations lead to a significant increase in labour costs in the formal economy and create the incentive to work in the informal economy.	Johnson, Kaufmann and Shleifer (1997), Johnson, Kaufmann and Zoido-Lobaton (2000), Schneider (2011).
Public sector services	Growth of the informal economy can be driven by lower tax revenues, that in turn then influence the quantity and quality of the offered goods and services in the public sector, and this can lead to an increase in taxes on individuals and firms, in spite of the deterioration in the quality of public goods. The consequence is an even stronger incentive to take part in the grey economy. Countries with higher tax revenues that are achieved by lower tax rates with less regulations, better rule of law and lower corruption levels have a proportionally smaller informal economy.	Johnson, Kaufmann and Zoido-Lobaton (1998), Feld and Schneider (2010).

⁷⁰ Schneider, K. (2015) – Outside the State – the Shadow Economy and Shadow Economy Labour Force.

Cause	Theoretical explanation	References
Tax Morale	The efficiency of the public sector has an indirect effect on the scale of the informal economy because it influences tax morale. Taxpayers are more inclined to pay taxes honestly if they get valuable public services in return. However, taxpayers comply more where this principle does not operate if the application of legislation is fair. Better tax morale and social norms can lead to a reduction in the probability that individuals will work in the grey economy.	Feld and Frey (2007), Kirchler (2007), Torgler and Schneider (2009), Feld and Larsen (2005, 2009).
Intimidation	In spite of the strong emphasis on intimidation in public policies aimed at the reduction of informality, very little empirical research has dealt with this issue. A certain number of empirical studies have shown that punishment does not have any negative effect on the informal economy, while the subjective assessment risk of registering irregularities does have an impact. The Granger causality test shows that the scale of the informal economy has an impact on intimidation policy, i.e. the higher the level of the informal economy, the more the government policy based on promoting penal policies is, while the policy of intimidation itself does not have an impact on a reduction in the informal economy.	Andreoni, Erard and Feinstein (1998), Pedersen (2003), Feld and Larsen (2005, 2009), Feld and Schneider (2010).

4.1. Causes of the Informal Economy - Perception

“The situation is sad. The hard economic situation should not be alleviated to the detriment of the workers. Business operations should be facilitated somehow, and employers should be relieved from some of the burdens, but in such a way that the workers are secured and insured.” – An informally employed woman whose entire salary is paid “cash-in-hand”.

The attitudes of the active population in Montenegro about the motives for taking part in the informal economy are taken from the Survey and they present a mix of the mentioned concepts.⁷¹ As for individuals, respondents say that the key motives for taking part in the informal economy are: the low standard of living, i.e. poverty, economic crises and unemployment; state policy and the work of the state bodies; and high taxes and contributions. However, when assessing the factors that drive employers not to declare their employees, members of the working population say that the key factors are the poor business results of the enterprises that make it impossible for them to operate in the

71 IPSOS (2014) – Informal Employment and the Grey Economy in Montenegro 2014.

formal economy (39%) and high taxes and contributions (34%). This further means that the citizens of Montenegro see the business environment and conditions for business operations as unfavourable.

The attitudes of employers correspond to the attitudes of the active population. Employers say that the key reasons for doing business in the informal sector are the poor business results of enterprises (46%) and high taxes and contributions (36%).

Informally employed people think that the conditions for business operations in Montenegro are difficult, particularly for small companies, and that stricter penalties would only lead to the closing of those companies that would not be able to operate in full compliance with the law. On the basis of this response by informally employed people, it is clear that they understand that stricter enforcement (penal policy) cannot solve the problem, i.e. that the consequences would be negative for both employers and informally employed people.

Representatives of the business sector say that the key challenges and obstacles to formality include⁷²:

- Numerous and high parafiscal charges (82% of employers)
- Poor business results (81% of employers)
- High taxes and contributions (75% of employers)
- High severance payments that have to be paid to employees in case of dismissal (66% of employers)
- The long period that the state takes for paying VAT rebate (64% of employers)
- The possibility for employees to use social support and other benefits intended for unemployed people (64% of employers)
- The short period that the law allows for fixed-term employment - two years (58% of employers)

More than a half of employers think that the benefits from informal employment are greater than the envisaged penalties, although they are relatively high for Montenegrin conditions and they range between €2,000 and €20,000. Given the above reasons for informality, it is clear that the burden of formal work is too high, so that employers would rather take the risk than declare their employees. Employers also justify this behaviour by their perception that there is a low probability that they will be punished anyway. This confirms the findings of empirical studies in other countries about the effects of “intimidation”.

The interviews that were conducted within the Survey with employers (IPSOS 2014) show that the tax burden is the reason why most employers opt not to declare their employees or to declare only their minimum wages for the purposes of paying the taxes and contributions stipulated in the law. However,

⁷² Since the question to employers offered the option of multiple-choice answers, this data is the percentage of the total number of employers that circled a certain answer. For example: 82% of employers thought that numerous and high parafiscal charges create obstacles to formalization.

employers would be willing to formalize their business operations if the tax rates and contributions were lower and if they could be convinced that legislation would be applied equally to everyone. The inequality of enterprises and entrepreneurs before the law is another cause that is perceived by employers as very significant for the informal economy and as an obstacle to formalization.

4.2. Causes of the Informal Economy - Evidence-Based

There is only scarce data available for assessment of the factors that predominantly determine the phenomenon and scale of the informal economy. The informal economy, and particularly the informal economy in the labour market, is not particularly monitored through the statistical surveys of the official statistics compilers. An exception is the survey of the Institute for Strategic Studies and Projections (ISSP) and the Employment Office from 2007, where within the Labour Force Survey a particular module was dedicated to the informal economy. A second survey that provided data about the scale of informal employment was conducted seven years later by IPSOS. Other factors that were established as important through empirical research are not monitored in Montenegro.

Table 4.2.1 - Correlation: Tax burden and employment in the formal sector

		Tax burden	Formally employed people
Tax burden	Pearson correlation	1	-0.909**
	Sig. (2-tailed)		0.000
Formally employed people	Pearson correlation	-0.909**	1
	Sig. (2-tailed)	0.000	
** The correlation is statistically significant at the level of 0.01 (2-tailed)			
Number of observations N=16			

Since statistics are available for the tax burden on labour costs⁷³ and since the volume of undeclared employment can be indirectly calculated by using the data from the Labour Force Survey⁷⁴ on the basis of the total number of employed people and the data on the number of employed people without a contract, the connection between these two phenomena can be presented through a very simple correlation. In this way we test the claims of employers and respondents from the working population about the impact of the tax burden on the scale of informal employment.

The correlation shows the direction of the changes in the employment in the formal sector under the influence of a change in the tax burden. The correlation between the tax burden and the total number

73 The tax burden of labour costs is calculated on the basis of the average salary in Montenegro and it is the indicator that shows how much per euro that the employer spends on labour costs goes to the employee and how much goes to the state in the form of taxes and contributions.

74 The data for the period from 1999 to 2006 comes from the Labour Force Survey of the Federal Statistical Office, while later data comes from MONSTAT's Labour Force Survey.

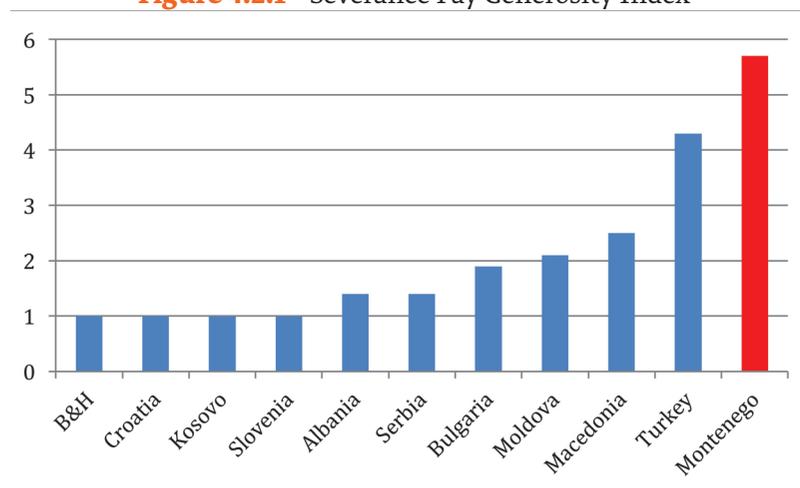
of formally employed people in Montenegro is negative and statistically significant. This means that every increase in the tax burden has a negative impact on employment in the formal sector. An increase in the tax burden does not mean only an increase for new employees but also for the existing ones, i.e. it means that an increase in labour costs can have an additional, negative impact of a reduction in the number of existing jobs in the formal sector and a smaller number of new jobs. At the same time, an increase at the macro level leads to less competition.

Table 4.2.2 - Correlation: Tax burden and employment in the formal sector

		Tax burden	Informally employed people
Tax burden	Pearson Correlation	1	0.534*
	Sig. (2-tailed)		0.033
Informally employed people	Pearson Correlation	0.534*	1
	Sig. (2-tailed)	0.033	
* The correlation is statistically significant at the level of 0.05 (2-tailed)			
Number of observations N=16			

The same is true vice-versa. The negative correlation between employment in the formal sector and tax burden points to the fact that a reduction in the tax burden increases employment in the formal sector. The correlation between the tax burden and employment in the informal sector is statistically significant and positive. This means that every increase in the tax burden increases employment in the informal sector, while every reduction in the tax burden has, as a consequence, a reduction in the scale of informal employment in Montenegro.

Figure 4.2.1 - Severance Pay Generosity Index

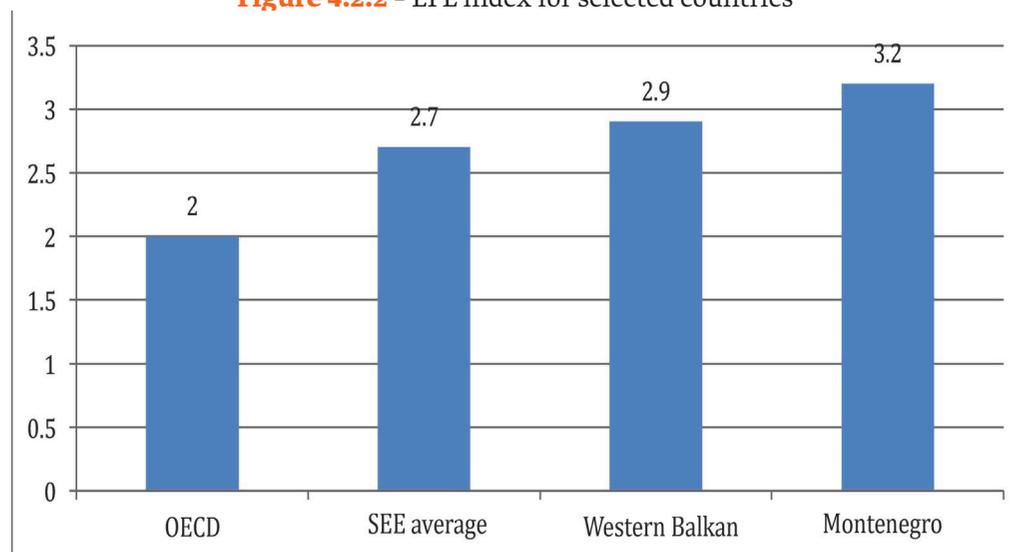


Source: World Bank (2012), Holzmann, Vodopivec (2012), Dolanc (2012).

In addition to the direct impact of the level of tax rates on formal and informal employment, regulation also has a significant impact on employment. This is also confirmed by the opinions of individual respondents. They think that regulation in the labour market is one of the factors that are decisive for informal engagement of employed people. This confirms the relevant theoretical and empirical findings (Heckman, Pages, 2004, Lemos 2007, Djankov, 2002) in the labour market of Montenegro that suggest that regulation in the labour market influences the scale of the informal economy through the high costs of job security (costs of dismissal), the level of the minimum wage, regulation of wages, etc.

In Montenegro the level of employment protection is relatively high in comparison to the EU and OECD member countries, with an employment protection level (EPL) index of 3.2 (in the range from 0 to 6, where 0 is flexible regulation and 6 is rigid regulation). Additionally, the Severance Pay Generosity Index (Dolanc, 2012) shows that among the countries of South-East Europe (SEE), Montenegro has the most generous severance pay system.⁷⁵ This generous severance pay system influences on one hand a reduction in dismissals, but on the other generates a smaller volume of new jobs or opens up jobs in the informal sector. Additionally, a generous severance pay system reduces the intensity of flows in the labour market and discourages employers from introducing new technologies. It also decreases productivity and economic growth (Holzman, Vodopivec, 2012).

Figure 4.2.2 - EPL index for selected countries⁷⁶



Source: wiiw (2009)

⁷⁵ The Severance Pay Generosity Index is measured on the basis of the amount of severance pay after one year of work, five years of work and 10 years of work. The value of the index is the number of weekly wages per year of work that an employed person is entitled to in case of termination of their work contract.

⁷⁶ Wiiw (2009) – Study on the Adjustment Capacity of Western Balkan Countries to External Shocks.

The results of protection of employment in the labour market (OECD, 2004) are primarily a lack of mobility in the labour market, a lower activity rate, a higher volume of long-term unemployment and a low rate of compliance and high level of the informal economy in the labour market. All the listed consequences of rigid employment are present in Montenegro.

4.3. Informal Employment and Human Development - Friends or Foes?

Empirical research (Suharto 2002) suggests that, although informally employed people are connected with poverty and are thought to be the poorest category in society, it does not always have to be the case.⁷⁷ When indicators of income are used together with other parts of the Human Development Index and when indicators of human and social capital are included, a different picture of informally employed people emerges and there are no significant deviations from the general population of employed people (Suharto, 2002). The explanation for this lies partly in the improvement of the services of social care and social security that are provided by the governments worldwide.

In Montenegro the Survey showed that informally employed people face a higher risk of poverty than formally employed people, and that the poverty risk rate is significantly higher for informally self-employed people.

The data shows that the value of the HDI in Montenegro has a negative impact on informal employment.⁷⁸ This means that the higher the level of human development, the lower the level of informal employment is and vice-versa. If we analyse informally employed people in Montenegro we cannot see any significant difference between them and formally employed people, except when it comes to education characteristics, where the rule seems to be: the higher the education level, the weaker the inclination to engage in the informal economy is. Without improvements in the education system, without increases in the enrolment and graduation rate, and without improvements in the overall quality of education and its connection to the labour market, Montenegro will not see any long-term improvements in the quality of jobs, in either formal or informal activities.

Additionally, from the perspective of human capital development, the lack of health insurance and appropriate health care, in spite of the relatively wide coverage of the overall population by health insurance, poses a significant challenge for policy-makers. A higher level of human development suggests improvements in the education system, higher enrolment rates and completion of schooling, as well as improvements in the overall health of the population. The HDI component, which is related to the growth of the economy if that growth is inclusive, contributes to an increase in the quality of life of individuals, thereby increasing the possibility of generating new jobs, i.e. growth of the formal economy. Therefore, human development has to be observed in an even broader context, that

77 Suharto, E (2002) - Human development and the urban informal sector in Bandung, Indonesia: The poverty issue, *New Zealand Journal of Asian Studies* 4, pp. 115-133.

78 A statistically significant negative correlation of 10%.

of policies that contribute to the growth and development of the economy and that at the same time bring benefits to citizens. Informality in employment should be observed also as a consequence of insufficient inclusivity of growth, particularly in countries with a very high HDI like Montenegro.

The negative link between informality and HDI means that, in addition to policies that are aimed at formalization of the existing jobs in the informal economy, particular attention should also be paid to education and improvement of the outcomes and quality of education. Health care, improvement of the quality of the system's services and particularly promotion of health and healthy lifestyles, as well as safety at work, will certainly contribute to the strengthening of human capital and have a negative impact on informality. The quality of jobs and working conditions also have a significant impact on health and human capital.

Although access to the services of the health and education systems does not cause serious problems for informally employed people, and in general for all citizens of Montenegro, the quality of the provided services and their efficiency are significant determinants/constraints for human development. Additionally, although social care services, with the exception of the pension system, do not pose any particular risk, the possibility that the system is open to abuse makes it inefficient and incapable of providing adequate and timely support to those that are really vulnerable.

4.4. Informal Employment and Social Care

Being deprived of social care services is one of the most negative consequences of the informal economy, since engagement in the informal economy, as a rule, deprives individuals of exercising their rights on the basis of social care. In Montenegro's case it is predominantly the case only for the pension insurance, because most often there is a way to ensure other rights through manipulation of the system.

Health care for individuals in Montenegro can be ensured in several key ways - through payment of contributions (formally employed people), insurance through other household members (parents in the case of children who are minors, and spouses in the case of unemployed people and through obtaining health insurance as a beneficiary of some of the social care programmes - through retiring, using social assistance or registration as unemployed). However, even in spite of these possibilities, there are groups e.g. farmers, who spend their whole their lives with agriculture as the core activity for satisfying their key needs, and who are still outside the healthcare system. Their exclusion, and in some cases also their distance, make their position particularly vulnerable. Although the position of these people has been conditioned by some of the earlier policies and inability of institutions to include them in an adequate manner, decision-makers should pay particular attention to these marginal groups and create conditions for their inclusion. This is particularly true since the level of people at risk of exclusion and marginalization in old age is still relatively high (self-employed people,

and particularly self-employed people in agriculture). On the other hand, registered farmers, who do not produce only for subsistence but also for the market, through the programmes intended for this group of people are guaranteed their rights to health insurance, among other things.

In using insurance through another household member or through some other programme of social care and participating in the informal economy, undeclared employees partly use the benefits of the formal economy as well. Using social care benefits, particularly social assistance while being informally employed ensures that the beneficiaries maximize their benefits (more details in the next chapter) and this reduces the incentives for formalization of their activities.

The practice of maximizing the benefits from the formal sector and from informal employment is particularly emphasized in the case of beneficiaries of material allowance for families. As mentioned above, one-quarter of the beneficiaries of material allowance for families are engaged in informal jobs. This provides them with the opportunity to receive benefits and to use a whole range of other privileges (subsidies for electricity bills, child allowance, financial support for purchasing textbooks, etc.). At the same time this group of users uses the most generous transfers, since these are people who are able to work and have children who are minors. Through this form of engagement with/manipulation of the system, of the total expenditure on social transfers (including pensions), approximately 10% every year is “wrongly” targeted.

Another novelty in the social care system in Montenegro is the new benefit for mothers with three or more children. This right was introduced through amendments to the Law on Social and Child Care adopted in the Parliament in spite of the negative opinion of the Government and without any reliable fiscal impact assessment. The Law has been implemented since January 2016. According to the amendments to the Law, mothers with three or more children have the right to a living allowance amounting to 70% of the average salary in Montenegro if they have worked for 25 years; or an allowance amounting to 40% of the average salary in Montenegro if they have been registered as unemployed with the Employment Office of Montenegro for 15 years. Although these solutions were motivated by the need to help women and mothers, the Law is discriminatory and it harms not only the rights of other women that do not meet the listed criteria, but also the rights of other employed people, specifically men. The key message of the Law to women is that their work is not a sufficient contribution, but that their key contribution to the society of Montenegro is to give birth to children, the more the better, but at least three. In addition to this, if we bear in mind that the existing replacement rate (the ratio between average pension and average salary) is 56.8%, this right becomes even more problematic from the perspective of motivation to do formal work. An average employed man or woman who has worked for the full period required for retirement (35 or 40 years respectively) and has acquired the right to a pension according to the regular requirements for retirement can expect to have a pension that will amount to 65% of their income before retirement⁷⁹, while a mother who has given birth to

79 Ratio of the average old-age pension and average net salary.

three children and has worked for 25 years will have a living allowance of 70% of the average salary in Montenegro.

According to the data of the Ministry of Labour and Social Welfare, there are 87,000 women in Montenegro that have given birth to three or more children, of whom 20,000 women have applied to use this right. By the end of February 2016 more than 3,000 women had waived their right to a pension, while about 11,000 women applied for the allowance because they had been registered in the records of the Employment Office for 15 years. We can assume that the remaining women are those who have worked for 25 years and are still working, but cannot expect such a large pension when they retire. This means that more than 15,000 women are now out of the labour market, or about 5% of the total active population have become inactive. In addition to this, given the fact that the existing social care system and institutional framework are inefficient in preventing beneficiaries from enjoying the benefits of both informal work and social care, with this new right, women who are hired informally will have even less motivation to formalize their work. Thus, an additional institutional motivation for the growth of informal work has been created.

It is important to mention also, that the key system for protection in old age, i.e. the pension system, suffers losses of revenues, while individuals who do not have any other formal working service and have contributions paid for them on lower salary levels, can expect to have low incomes in old age – mostly the minimum pensions guaranteed by law. From the perspective of the pension system, in spite of the existing lack of revenues, on one hand this situation will reduce total expenditure, while on the other it will increase the need to have part of the unearned pensions compensated, since the minimum pension is guaranteed.

Pension systems of inter-generation solidarity, which include the Montenegrin pension system, are modelled in such a way that with a minimum formal working history, regardless of the level of incomes, individuals are ensured a minimum pension that is approximately 20% of the average salary in Montenegro. This amount, of course, is not a sufficient source of income for individuals, but for a person who was earning the minimum wage, this pension is a 50% replacement, which means that the amount of the pension of someone who was working for the minimum wage will be at the level of 50% of the last salary they received, which is a replacement rate close to that used in EU countries.⁸⁰

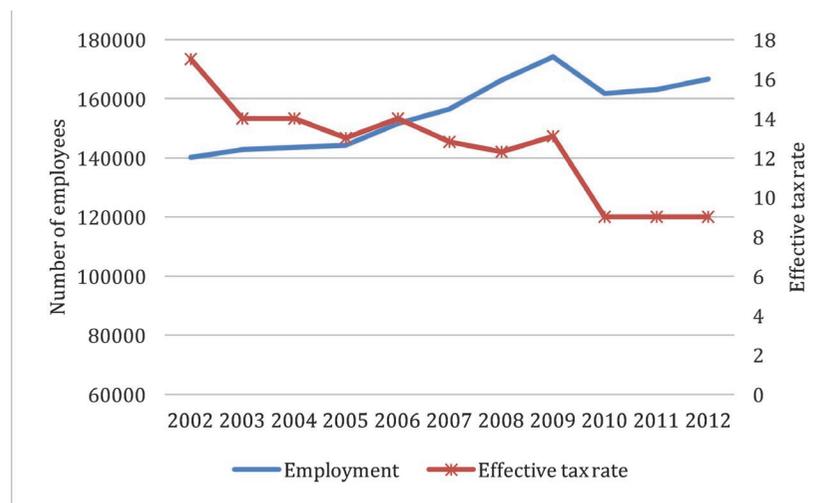
4.5. Informal Employment and the Tax System

Since the 2000s, the reforms of the tax policy, primarily the introduction of Value Added Tax and the reform of taxation on income and profit, have had a positive impact on tax morale and the scale of the informal economy. The available data shows that the scale of unregistered unemployment in absolute figures is largely constant, while there has been a significant growth in formal employment. In the

⁸⁰ The replacement rate is the ratio of the incomes after and before retiring, i.e. the percentage of the last salary that the retired person obtains in the form of a pension.

period since 2002 the effective tax rate has reduced by 10 pp (or approximately one-fifth), while formal employment has increased by approximately one-quarter (23.7%)

Figure 4.5.1 - The number of registered employed people and the effective tax rate



The positive features of the tax policy are the stimulation effect of the policy through the decrease in the total tax burden on labour costs and the strengthening of the tax discipline, primarily through the improvement of the collection of income tax.⁸¹ A reduction in the effective tax rate in the period from 2002 to 2008 by approximately 10pp resulted in a growth of revenues from the income tax of almost 100%.

Source: MONSTAT and the author's calculations

In addition to the effective income tax rate, in the period since 2002 the total tax burden on labour costs has been reduced (by more than 10pp) inter alia through the reduction of the compulsory social insurance contribution rates (from a total of 24% to 20.5% for pension insurance and from a total of 14% to 12.3% for health insurance, whereby half of the costs were paid by employers and half by employees). In 2010 the structure of the burden changed. The contributions to be paid by employees increased, while those paid by employers declined. This change led to the situation where the majority of employers kept their net earnings at a constant level and increased the gross salaries, which in turn led to an increase in the overall tax burden on labour costs, since gross salaries constitute the basis for calculation the employer's part of the contribution.⁸²

81 The tax burden of labour costs is an indicator of the ratio between the cost of net salaries and compulsory taxes and contributions. The tax burden shows how much of each euro spent on labour costs goes to the people who are employed, and how much is paid in the form of taxes and contributions.

82 Gross salary consists of the net salary plus personal income tax and contributions paid by the employee.

Table 4.5.1 - Trends in the income tax rate and revenues from income tax

Year	Effective income tax rate	Collection in millions of €	Year	Effective income tax rate	Collection in millions of €
2002	19	57.90	2008	12.3	111.92
2003	14.1	63.90	2009	13.1	94.99
2004	14.0	61.24	2010	9.0	89.75
2005	13.3	67.09	2011	9.0	81.64
2006	12.4	72.49	2012	9.0	82.26
2007	12.8	85.40	2013	9.0	95.60

Source: Ministry of Finance

Regardless of the reduction in the tax burden on labour costs (which shows what share of the costs of labour is paid to the state in the form of taxes and contributions and what share is given to the employee in the form of a salary) that has happened in the last 15 years, the tax burden in Montenegro (MF 2014) is 3pp higher than the European Union average (36.7%) and 4pp higher than the average for Eurozone member states (35.5%). The average tax burden on labour costs in Montenegro is 5pp higher than the average for OECD Member States (34.8%), which are the most developed economies in the world.

In addition to the amount of the tax burden, the administrative burden - the cost of paying taxes - is also a particularly important part of the tax system from the perspective of formalization. Regardless of whether tax rates are low, if it is administratively complicated and expensive to pay taxes, and if, in addition to this, discretionary and variable rules are in force, then the total system is expensive and irrational, both for the state and for the taxpayers.

Relevant studies show that in Montenegro it is very complicated to pay taxes, particularly if you are an individual or are self-employed. One of the sub-indicators of the Ease of Doing Business Index is the paying taxes index.⁸³ If we observe only the total tax rate as a percentage of profit, then Montenegro is 23rd out of 189 countries. However, if we include the indicators of the number of payments, procedures and the time required for calculating, reporting and paying taxes, Montenegro is 98th out of 189 countries. An average small enterprise spends 320 hours and takes in total 29 hours a year to comply with the tax legislation.

83 Doing Business Index

Figure 4.5.2 - Paying taxes



Source: World Bank, Doing Business Report 2015.

Although the concept of the minimum wage is completely different and serves to protect the minimum income of employed people, in Montenegro it is commonly understood as a parafiscal instrument. Since the increase of the minimum wage in 2013 (from the pre-2013 level of 30% of the average wage), the amount of the tax debt for taxes and contributions significantly increased. Additionally, the concept of the minimum wage in Montenegrin conditions is acquiring a new dimension from the perspective of formalization. Research shows that the average income of self-employed people, who make up a half of undeclared employed people, is at the level of the minimum wage without any taxes or contributions.

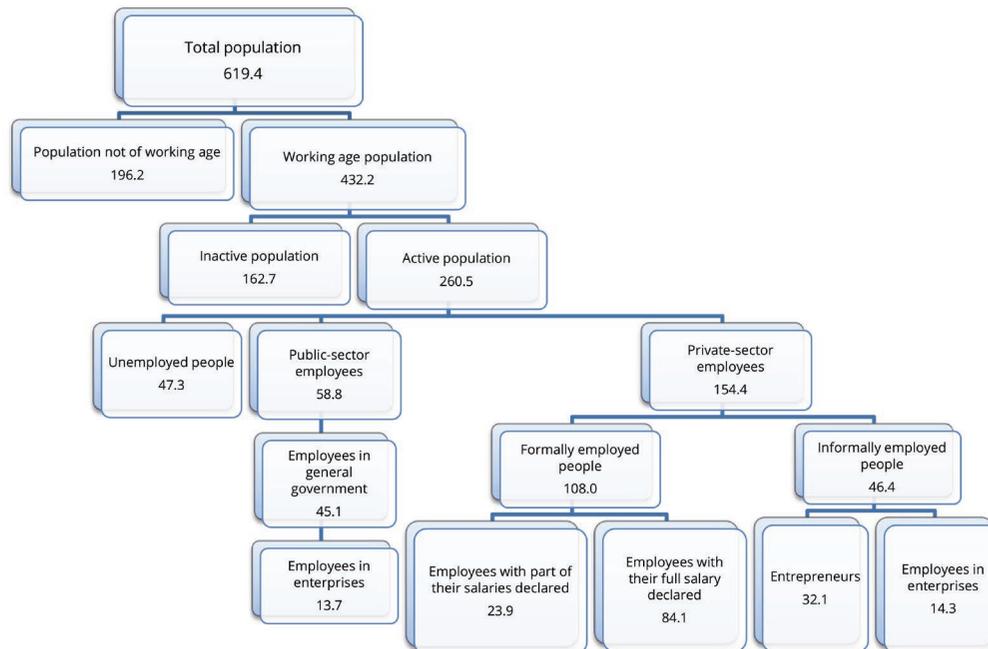
One of the problems that companies in Montenegro face, according to the Survey, is VAT legislation, particularly the part related to VAT refunds and the procedures related to it. If a company acquires the right to VAT refunds, the deadline within which the state has to administer it is 60 days. However, since within the procedure, before refunding the tax the tax authorities send their inspectors, it can sometimes take as long as six months to obtain the refund. The research conducted in Montenegro shows that application of VAT legislation, in addition to the above, also generates high administrative costs that are related to the need to calculate, document, archive and report VAT. They are roughly at a level of 18% of the total revenue from VAT. This means that through compliance with VAT legislation, in addition to the approximately €500 million that is annually paid in the form of tax, companies have an additional cost of about €100 million that could be used in a much more productive way (Bošković, 2015).

4.6. Informal Employment and Unemployment

According to the data from MONSTAT's Labour Force Survey for 2014, of the total population in Montenegro of 620,000, 432,000 people are of working age, while 260,500 are active. Among the active population, 47,300 are unemployed, while 213,200 are employed. In the group of people who are engaged in work, the number of informally employed people, according to the survey, is 46,400. It is clear that if these jobs did not exist, this would double the number of unemployed people. Although engagement in the informal economy is not a desirable way to be engaged as an individual, participation in informal activities decreases inactivity and unemployment among the active population. This fact is particularly important since around 70% of undeclared employed people in Montenegro are undeclared self-employed people, which highlights the development of small-scale entrepreneurship within the informal sector.

An assessment based on the Employment Office's and MONSTAT's unemployment data shows that informal employment has a significant impact on the unemployment rate, but also that the impact of informality on the reduction of the unemployment rate is gradually declining. This additionally indicates that a smaller influence of employment in the informal sector on the reduction of the unemployment rate does not mean a reduction in the volume of informal employment but a faster growth of formal employment.

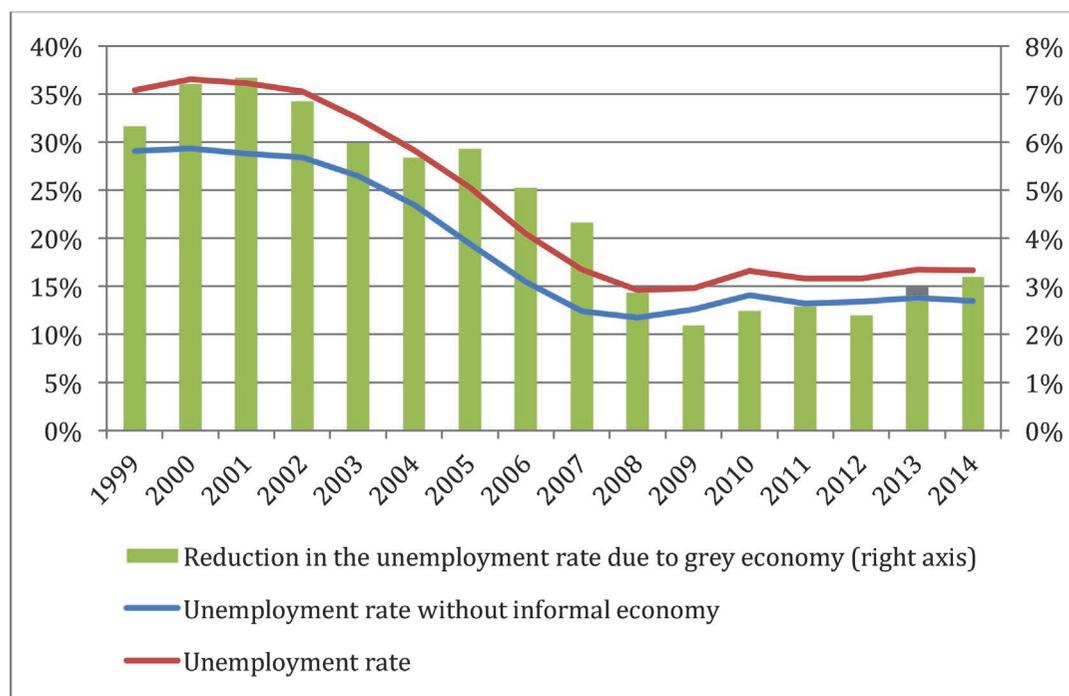
Figure 4.6.1 - Presentation of the population of Montenegro by activity (in thousands)



Source: MONSTAT - Labour Force Survey 2014, VCG - Plan of internal reorganization of the public sector, IPSOS and the author's calculations.

In the early 2000s informal employment led to a reduction of the unemployment rate by approximately 7pp, while in 2014 the unemployment rate was 3pp lower courtesy of informal employment. The reason for the reduction of the impact in terms of percentage points was caused also by an absolute reduction of the unemployment rate. If we analyse to what extent the unemployment rate is lower if we include the informal economy in relation to the unemployment rate without the informal economy, we can conclude that on average the informal economy reduces the unemployment rate by approximately one-quarter.

Figure 4.6.2 - Influence of informal employment on the unemployment rate



Source: Employment Office, MONSTAT and the author's calculation

4.7. Informal Employment and the Education System

Montenegro went through major changes during the transition period, but the structural problems such as a high inactivity rate, a high percentage of long-term unemployment and particularly a mismatch between structural supply and demand for labour still exist in the labour market in Montenegro.

The Montenegrin labour market is currently fragmented and segmented because there are huge regional inequalities and mismatches between supply and demand for labour. The reasons for the

mismatch are numerous, one of them definitely being the existing education system. Enrolment policy in Montenegro is characterized by a lack of high-quality cooperation between the key stakeholders, i.e. higher education institutions, ministries, the Employment Office, employers and other relevant institutions. This has been recognized in strategic documents, which note that existing cooperation is more of a formal than of a substantive nature.⁸⁴

Other reasons for the mismatch between supply and demand in the labour market include insufficient institutional capacities, which is primarily reflected in the lack of research in the field of education into issues like education needs, the adequacy of the education supply, levels of functional literacy, levels of development of the key competences, as well as the levels of the match between education possibilities and the market's labour needs. The register of the Employment Office of Montenegro contains a relatively high number of registered occupations for which there is no demand in the labour market, while on the other hand there are occupations that are not registered and there is a demand for them.

There are numerous methods for measuring the “mismatch” in the labour market, including the Beveridge curve,⁸⁵ the coefficient of variation, variance of the specific employment, i.e. unemployment rate, return to education, relation between their proportion of unemployment and proportion of employment, the mismatch by occupation, etc. All the methods have their advantages because they measure and explain the mismatch in the labour market from different aspects.

The Beveridge curve, as one of the methods for measuring the mismatch in the labour market, is the representation of the relationship between the unemployment rate and the rate of vacancies that are not filled at several different points in time. It shows the dynamics of the process of matching supply and demand in the labour market. To be more precise, the Beveridge curve shows all the combinations of the unemployment rates and vacancies not filled on the basis of the available data during a certain time period. The curve does not have to match the real “trajectory” of the data through time, since the shifts can at the same time be the result of shifts along the curve and the shifts of the curve itself. The data does not allow disaggregation of these two possibilities.⁸⁶

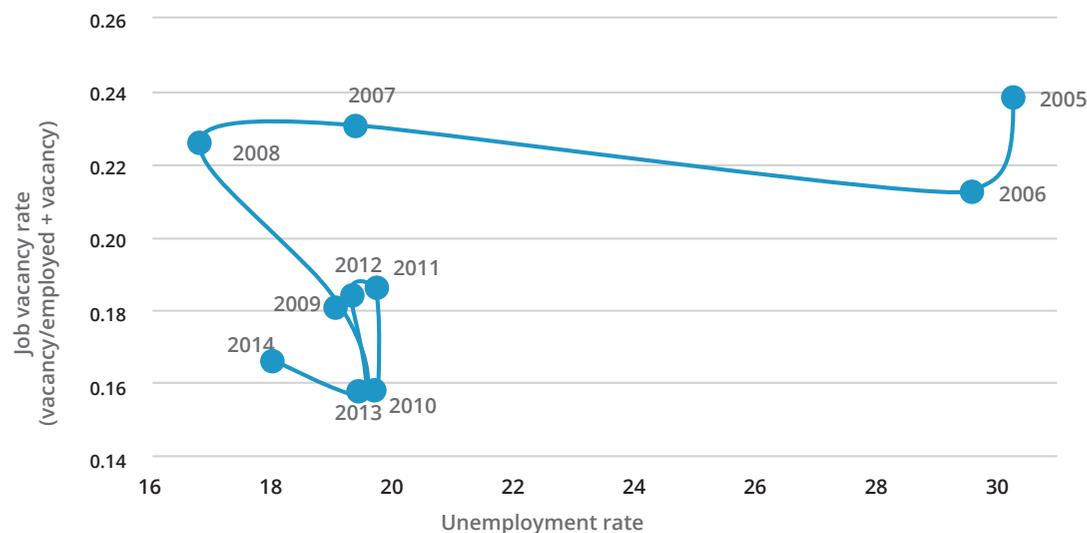
The number of vacancies has grown in previous years but, on the other hand, the unemployment rate grew after the crisis, which reflects the imbalance between supply and demand for labour. An important increase in registered vacancies was caused by the activities aimed at the legalization of informal jobs in 2003. The largest net increase in registered vacancies of about 15,641 was recorded in 2007. After the decline in the number of vacancies in 2013, it grew again in 2014 by 14.3%.

84 Programme of Reform of the Employment Policy in Montenegro 2015–2020, (2015), Ministry of Labour and Social Welfare of Montenegro.

85 A negative relationship between unemployed people and vacant jobs was for the first time identified by William Beveridge in the 1940s, when he was trying to establish how far the economy is from the condition of full employment (Bleakly, H. and Fuhrer, J. C., 1997. “Shifts in the Beveridge curve, job matching and labour market dynamics”. *New England Economic Review*, Sep/Oct, p. 3).

86 Gatelli, D. & Johansen, J. (2011), *Measuring Mismatch in ETF Countries*, A Methodological Note, ETF, p. 8.

Figure 4.7.1 - Beveridge curve⁸⁷ for the labour market of Montenegro



Source: The author's calculations, ETF, MONSTAT, Employment Office of Montenegro.

On the basis of the Beveridge curve for the Montenegrin labour market it can be concluded that the trajectory of the curve in the last few years has been particularly driven by the crisis, but that the mismatch is also strong. Still, every shift of the Beveridge curve towards inside shows a growth in the efficiency of the functioning of the labour market, i.e. a better match between the vacant jobs and job seekers. A new education programme that has resulted from the market needs, and the use of additional training and retraining for certain occupations that are in higher demand in the labour market, are influencing the faster filling of vacancies, i.e. they are influencing a reduction in the number of unemployed people and the number of vacancies at the same time. In such a way the use of an employment programme increases the efficiency of matching supply and demand for labour, which leads to shifts in the Beveridge curve to the inside.⁸⁸ The Beveridge curve suggests that the crisis led to a deterioration in the unemployment rate. However, in 2014 the curve shows an even larger mismatch between supply and demand in the labour market.

Active labour market policies are implemented with a view to reducing the mismatch of supply and demand in the labour market. Still, the education system is more important for the reduction of the level of mismatch of supply and demand in the labour market than the direct active policies implemented by institutions responsible for the efficiency of the market. Numerous empirical analyses have shown

⁸⁷ The Beveridge curve is also known as the UV curve (unemployment–vacancies curve).

⁸⁸ Calmfors, L., 1994. "Active Labour Market Policy and Unemployment – A Framework for the Analysis of Crucial Design Features. OECD Economic Studies, 2 (1), pp. 7–47.

that active policies in the labour market are not of decisive importance and that they do not have a decisive effect on a reduction of the mismatch. Some of the conducted analyses lead to the conclusion that generating jobs contributes to a reduction in the mismatch, but not significantly.⁸⁹ On the basis of the existing aggregated analyses it can be concluded that the overall impact of active policies (training, retraining, etc.) in the labour market is insufficient, i.e. that the system of formal education itself at all levels should be more aligned with the needs of the labour market and should not require any additional expensive retraining.

89 Obadić, A. (2003), Influence of Active and Passive Policies on the Labour Market, *Financial Theory and Practice* 27 (4) p. 541.

CHAPTER 5: PRODUCTIVITY AND ACCESS TO CAPITAL/DEVELOPMENT

The productivity of enterprises and efficient use of resources are of key importance for economic growth. Empirical analyses of the development of the Montenegrin economy since 2000 show that an average growth of productivity in Montenegro of only 0.6% would release potentials for real GDP growth of 4–5% a year.⁹⁰ Analysis of the causes of the growth of Montenegrin economy in the period 2000–2010 shows that one-quarter of GDP growth can be explained by the contribution of growth in the labour force, while the rest is explained by the accumulation of capital (Madžarević-Šujster, Popović, 2012). These findings suggest that a growth in productivity is not the cause of the growth and that it did not significantly contribute to the growth of the Montenegrin economy in the period 2000–2010.⁹¹ Therefore, decision-makers have to focus on productivity growth and on structural reforms that will ensure productivity growth. Structural reforms that will emphasize productivity have to focus primarily on the labour market and a reduction in the volume of inactivity, as well as on a reduction in the state’s policy of intervention, both in terms of social policy as a “ticket” to inactivity and less intervention by the state and in terms of “rescuing” companies that used to be owned by the state or those that are still owned by the state today.

Interventionism and institutional “tolerance” of non-compliance with legislation by companies owned by the state have multiple negative consequences for productivity of the business sector and for tax morale in general. Such conduct and constant interventions in state companies, give wrong incentives to the business sector, so instead of competing in terms of productivity and growth, they compete in terms of who will pay less tax and/or who will get more transfers from the state budget and be compensated in this way for the profit that would otherwise be earned through the growth of productivity and more efficient use of resources. In the same way, since the state frequently finances tax obligations from the general tax revenues and contributions for companies owned by the state or which used to be owned by the state, the failure of employers to pay contributions is absolutely rational, since there is a high probability that the debts for taxes and contributions will be financed by the state, i.e. that regular taxpayers (those who regularly pay all their taxes and contributions) will in the end cover the total cost.

In addition to this, the constant “improvements” in social care for certain groups give the signal to individuals that inactivity is all right, and that in the end somebody else will take care of their wellbeing. Such an environment cannot encourage, either in the short run or in the long run - and particularly given the demographical trends - the release of the potentials for the development of individuals or the growth of productivity, the business sector and the economy in general.

90 World Bank (2013) – CEM Montenegro: Preparing for Prosperity.

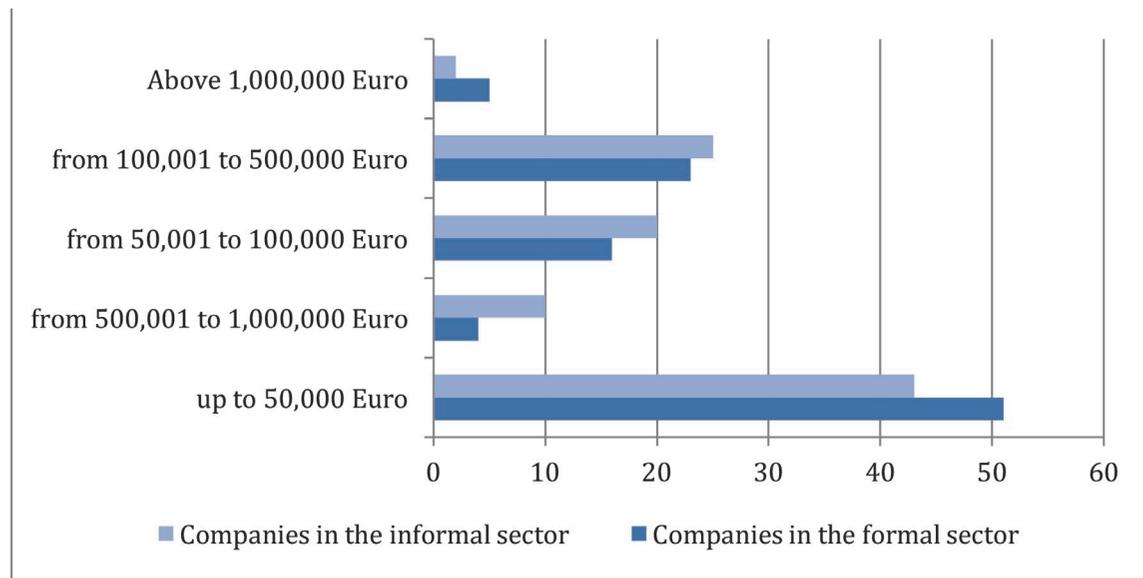
91 Ibid.

5.1. Productivity in the Formal vs. Productivity in the Informal Sector

“Even laypeople are aware that if I went completely over to legal operations, I would not get any contract from investors and I would have to increase my prices. The clear calculation is that I would have higher costs. If the conditions in the market were the same for everybody and if everybody had to pay all the duties in Montenegro, it would automatically mean an increase in prices.” – An entrepreneur.

The data from research shows that there are no significant differences in terms of the basic financial indicators of companies that are formal (that pay all their taxes) and companies that are partially engaged in the informal sector (have informally employed people and/or do not declare part of their turnover). Two-fifths of the companies engaged in the informal sector earn incomes of up to €50,000, while this is the case for a half of all formal companies. One-fifth of informal companies generate incomes of €50,000–€100,000, while one-quarter of informal companies generate incomes of €100,000–€500,000. The incomes of formal companies are similar, which is probably a consequence of the fact that both formal and informal companies predominantly operate in the formal sector, although the research is divided into formal and informal companies.

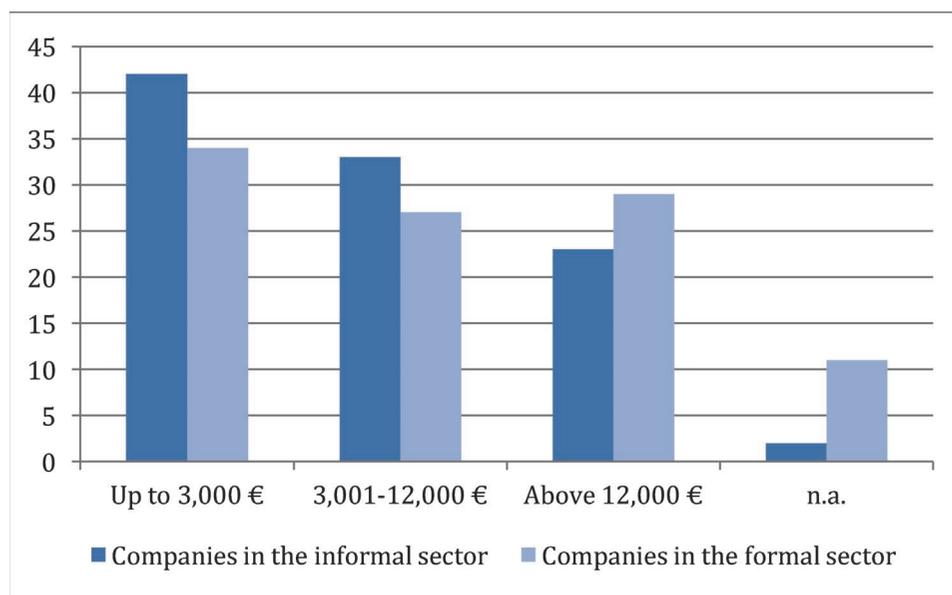
Figure 5.1.1 - Generated incomes



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

The data on the amount of profit indicates a similar picture as the data on incomes, but a higher percentage of informal companies have a lower profit, i.e. a profit of up to €3,000 annually.

Figure 5.1.2 - Profit made by companies



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

The data shows that when it comes to companies there is no significant difference in productivity between the formal and informal sectors.⁹² However, if we observe self-employed people, i.e. entrepreneurs, the differences in productivity and incomes/productivity are significant. Registered or formal entrepreneurs have incomes that are 50% higher than unregistered or informal entrepreneurs. One explanation for such a difference is that they do different activities. Most informal entrepreneurs are engaged in agriculture on their own farms, while a significant number are engaged in services. Informally self-employed people usually have lower education levels than those who are formally employed. This suggests that a significant number of individuals able to work in Montenegro are hired within unproductive activities.

Also, given the connection between education and informality, as well as the fact that improvements in the education structure of the population was a significant source of the growth of Montenegrin GDP in the period after the war (contributing to a growth of 46%), and that the return rate to tertiary education is 20%, we can conclude that the education system has a significant role in the improvement

⁹² This is a temporary conclusion to be validated when a basis is available.

of productivity and growth.⁹³ However, in spite of the low activity in the labour market, a relatively good education structure of the population and a relatively high unemployment rate, every year Montenegro “imports” a number of employees that is equal to the number of unemployed people in Montenegro. The common understanding is that the reason for this is a lack of qualified labour with the skills that employers need and it indicates the failure of the education system to ensure that the profiles produced by the education system have the necessary skills for successful integration in the labour market and for finding employment.

5.2. Opportunity Costs of (In)formality

On one hand, the informal economy means significant incomes for individuals and opportunities for employment in the situation where the supply of vacant jobs in the formal sector is limited. Observed from the perspective of individuals, particularly those that are undeclared as employees working for an employer, net salaries in the informal sector are slightly lower than salaries in the formal sector. Thus, if we assume that the costs would remain the same for the employer, formalization would mean significantly lower income or net salaries for individuals. The incomes of this group of employees would be at most 40% lower, which is the amount of the tax burden if we assume that employers would strive to keep labour costs unchanged.

A half of undeclared employees are undeclared self-employed people. Given the fact that incomes from informal activities are low anyway – they are on average at the level of the minimum wage defined in the law – formalization of these jobs would mean that individuals would have to deprive themselves of at least 50% of their total income and they would get the prospects of a pension instead. Since individuals, particularly younger people, attach more value to the present than to the future, voluntary formalization is not very likely in this group of undeclared employed people.

At the level of the total population, the estimated lower income from taxes and contributions amounts to €140 million annually (IPSOS, 2014). This would mean an increase in the expenditure of the business sector by the same amount or, if we assume that costs are to remain constant for businesses, this would mean a reduction in the available household income by €140 million and the loss of a significant number of jobs in the informal sector. A repressive policy aimed at formalization without adjustments in the formal institutions and gradual formalization would mean an increase in poverty, since the incomes from informal activities have a significant impact on poverty reduction. This means that it is not enough to take into account only the lost revenue of the state without taking into account other consequences. It does not give us the full picture. Ultimately, insisting on repressive measures to enact a formal transfer from the informal to formal sector could have a negative effect on the economic and social system in Montenegro.

93 World Bank (2013) – CEM Montenegro: Preparing for Prosperity, pp. 10–11.

The key costs of companies in the formalization process include an increase in expenditures for paying taxes and other fees and compensations, as well as an increase in administrative costs, since formal economic entities are obliged to keep accountancy records and to prepare various types of reports for institutions. In addition to these costs, the direct costs of compliance with rigid regulations would also be increased - applying the minimum wage, severance pay in case of termination of employment contracts, compensation for vacation, sick leave, additional payments for night work, overtime and work on holiday. These are lower or non-existent in informal employment (Arandarenko, Simović, 2015). For individuals, the costs of formalization primarily include a reduction in available income and limitations in terms of engagement in additional activities, since they would have to request formal approval from the employer.

Table 5.2.1 - Identification of the key costs of formalization by the type of informal work in Montenegro

Type of cost	Households and employed people that work in their own households	Informal companies, informally employed people	Formal companies, informally employed people	Formal companies, formally employed people, partially declared salaries
Costs of registration - companies	Yes	Yes	No	No
Costs of registration - employed people		Yes	Yes	No
Costs of taxes and contributions	Yes	Yes	Yes	Yes, a part
Costs of compliance with the labour regulations	No	Yes	Yes	Yes, a part

Source: Enabling the Transition to Formal Employment in Montenegro, M. Arandarenko, V. Simović (2015)

Why is formalization important? ILO Recommendation No. 104 emphasizes that the transition from the informal to the formal economy is the key to inclusive development and decent work for all. As a rule, formalization brings benefits for both the companies that function in the informal sector and the individuals that are engaged in the informal sector. The key benefits from formalization for employed people include elimination of deprivation in terms of insurance and vacation, as well as ensuring decent working conditions, which is not the case for self-employed people who make up two-thirds of the people informally employed in Montenegro. For undeclared self-employed people formalization would mean the loss of one part of their incomes, but it would also mean access to services provided by the public sector and participation in the programmes provided by the state to encourage entrepreneurship, access to bank loans, etc., as well as better opportunities to develop their businesses.

The benefits of formalization for companies include access to financing, using the incentives offered by the state, implementation of contracts and avoiding penalties.⁹⁴

Table 5.2.2 - Key benefits of formalization by the type of informal engagement in Montenegro

Key benefits	Households and employed people that work in their own households	Informal companies, informally employed people	Formal companies, informally employed people	Formal companies, formally employed people, partially declared salaries
Benefits of registration – companies	Access to financing sources Avoiding penalties	Access to financing sources Avoiding penalties	n/a	n/a
Benefits of registration – employed people		Avoiding penalties, Improved safety at work, improved certainty of employment	Avoiding penalties, increasing certainty of employment	n/a
Benefits of paying taxes and contributions	Access to social care services (for employed people) Improved public services	Access to social care services (for employed people) Improved public services (all)	Access to social care services (for employed people) Improved public services (all)	Full access to pension insurance (employed people) Improved public services (all)
Benefits of compliance with labour regulations (employed people)	No	Set of rights stemming from labour legislation	Set of rights stemming from labour legislation	No

Source: Enabling the Transition to Formal Employment in Montenegro, M. Arandarenko, V. Simović (2015)

The benefits of the formalization of informal engagement depend on the type of engagement and, as a general rule, higher benefits from formalization mean higher costs from formalization (Arandarenko, Simovic, 2015).

⁹⁴ In the case of doing business in the informal sector without any written contract, if the contract is not enforced, the provider of goods or services cannot complain to any institutions or seek protection. An example can be a self-employed person doing construction work. If a contractor does not pay for the work, such a self-employed person will not have any legal option to collect his/her claims.

CHAPTER 6: **THE 2030 AGENDA FOR PROMOTION OF PRODUCTIVE EMPLOYMENT AND DECENT WORK**

“Ensuring life with dignity”

United Nations

The concept of the Millennium Development Goals helped to enhance national and global efforts on defining and implementing policies aimed at the improvements of the quality of life of all individuals, with a particular emphasis on the reduction of extreme poverty, access to health services and improvement of the health of the population, a reduction in gender differences and preservation of the environment. The Millennium Development Goals are as follows:

MDG 1 - To eradicate extreme poverty and hunger

MDG 2 - To achieve universal primary education

MDG 3 - To promote gender equality and empower women

MDG 4 - To reduce child mortality

MDG 5 - To improve maternal health

MDG 6 - To combat HIV/AIDS, malaria, and other diseases

MDG 7 - To ensure environmental sustainability

MDG 8 - To develop a global partnership for development

Since three of the eight MDGs were met before 2015 (MDGs 1, 3 and 7) with various successes of national economies, a global debate about the future we live in and a global partnership for development was organized under the auspices of the United Nations system. After a debate that lasted two years, in a summit in New York held on 25–27 September 2015, the heads of state and governments of UN member states adopted the resolution “Transforming Our World: the 2030 Agenda”⁹⁵. The Agenda contains 17 comprehensive, far-reaching goals focused on people, dedicated to achieving sustainable development within the three key dimensions: economic, social and environmental.

95 <https://sustainabledevelopment.un.org/post2015/transformingourworld>.

Goals of the 2030 Agenda for Sustainable Development or SDG (Sustainable Development Goals):

Goal 1. End poverty in all forms everywhere
Goal 2. End hunger, achieve food security and improved nutrition and promote sustainable agriculture
Goal 3. Ensure healthy lives and promote well-being for all at all ages
Goal 4. Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all
Goal 5. Achieve gender equality and empower all women and girls
Goal 6. Ensure availability and sustainable management of water and sanitation for all
Goal 7. Ensure access to available, reliable, sustainable and modern energy for all
Goal 8. Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all
Goal 9. Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation
Goal 10. Reduce inequality within and among countries
Goal 11. Make cities and human settlements inclusive, safe, resilient and sustainable
Goal 12. Ensure sustainable consumption and production patterns
Goal 13. Take urgent action to prevent climate change and its impacts
Goal 14. Conserve and sustainably use the oceans, seas and marine resources for sustainable development
Goal 15. Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss
Goal 16. Promote peaceful and inclusive societies for sustainable development, provide access to justice for all and build effective, accountable and inclusive institutions at all levels
Goal 17. Strengthen the means of implementation and revitalize the global partnership for sustainable development

In light of the 2030 Agenda and the Millennium Development Goals, Montenegro met the goals that referred to maternal and child health (MDGs 4 and 5) and the goal related to the partnership for development. The goals that Montenegro only partially achieved are MDGs 2, 6 and 7, while in other areas the progress was not sufficient. In that respect in the coming period, on the basis of its success/failures in achieving the Millennium Development Goals, Montenegro will define its new strategy and priorities in the achievement of the Sustainable Development Goals.

The 2030 Agenda ensures support for various national and regional social and economic needs because the defined goals include issues that are recognized as decisive in the future development of Montenegro, such as full employment, social inclusion of vulnerable groups, decent work, rule of law, a green economy, high-quality education, gender equality, etc.

One of the Sustainable Development Goals is to ensure decent work, which was initially the initiative of the International Labour Organization. Work is seen here as the basis of the wellbeing of every individual.

Decent work includes:

- Gender equality incorporated into all aspects of work
- Promotion of the opportunities to generate new jobs - an economy that generates opportunities for investments, entrepreneurship, development of skills, generating new jobs and sustainable income sources
- Guaranteeing human rights and safety at work
- Adequate social care - health insurance, unemployment benefit

In light of the 2030 Agenda we should also observe the five dimensions of human development promoted by the Global Human Development Report for 2015 which focuses on the initiative for decent work.⁹⁶ Not every type of work enhances human development (Jahan, 2015), and in order to explore the contribution of work to human development we need to analyse the following five dimensions:

- Rethinking and extending the concepts and ways to create work - traditional work, work through taking caring of other household members, volunteer work, creative work - all of which contribute to the growth of human development
- Linkages between work and human development - observing both positive and negative links particularly in relation to certain types of work that do not contribute to human development - slavery, child labour, illegal prostitution, crime, work without dignity, exploitation of migrants
- The concept and definition of work - the slow disappearance of traditional work related to the office or production plant, technology ensured so that work can be done anywhere, and therefore traditional employment strategies and approaches to employment policies do not produce results any more, new skills are required for the new world
- Awareness and extending of choices - technology ensured so that people are compared in terms of the manner in which they are treated, the rights they have and how they live. The number of “things” that can be hidden is increasingly small. Individuals increasingly do not want to rely on the solutions provided by governments or the international community. We live in a world of inequality, unsustainability and uncertainty, and individuals increasingly want their voice to be heard, so protests and conflicts will become more and more frequent.
- Income - income is not the essence of human life nor is a lack of income the essence of deprivation - human rights, security and freedom of choice are much more important

⁹⁶ Selim Jahan - speech on the Human Development Report for 2015 (<http://hdr.undp.org/en/rethinking-work-for-human-development>).

The concept of decent work and full and productive employment with the promotion of continuous, inclusive and sustainable economic growth is particularly underlined through Goal 8 of the 2030 Agenda. The same concepts are integrated into the national strategic framework, primarily through the Draft National Strategy for Sustainable Development by 2030 (NSDS), the Strategy of Employment and Development of Human Resources 2016–2020, the document Directions of Development 2015–2018, etc.

The targets within this goal that are relevant for Montenegro and its national context include:

- To achieve higher levels of productivity through focus on high-value-added and labour-intensive sectors (8.2)
- To promote decent job creation, entrepreneurship and encourage the formalization and growth of micro-, small- and medium-sized enterprises (8.3)
- To decouple economic growth from environmental degradation (8.4)
- To achieve full and productive employment and decent work for all women and men, including young people and people with disabilities, and equal pay for work of equal value (8.5)
- To substantially reduce the proportion of youth not in employment, education or training (8.6)
- To eradicate forced labour and child labour in all its forms (8.7)
- To protect labour rights and promote safe and secure working environments for all workers, including migrant workers, in particular women migrants, and those in precarious employment (8.8)
- To promote sustainable tourism that creates jobs (8.9)
- To improve access to financial services (8.10)

These and the other 2030 Agenda goals are particularly present in the draft of the National Sustainable Development Strategy (NSDS) by 2030. SDG8 is elaborated in the strategic goals that refer to encouragement of employability and social inclusion, an increase in the level of competitiveness of the Montenegrin economy for sustainable development and green jobs, as well as for overcoming the lack of managers and strengthening of corporate social responsibility. For each of the goals in this document there are clearly defined measures, sub-measures and outcomes to achieve progress by 2030.

The Programme for Decent Work for Montenegro for the period 2015–2017 that was adopted in 2015 in line with the key priority of the Government of Montenegro and the UN Development Assistance Framework (UNDAF) for 2012–2016 is also in line with SDG8. This programme promotes decent work as the key component of development policies and it is based on equal opportunities for women and men to get decent and productive jobs in conditions of freedom, equality, safety and human dignity.

Most of the other strategies that have been adopted in Montenegro are based on the defined development priorities that are in line with some of the goals of sustainable development of the 2030 Agenda. Still, the problem that has been recognized in the draft of the NSDS is the fact that a large number of these documents do not have any permanent coordination structure for implementation or secured sources of funding by type and years. In addition to this, the NSDS identifies the problem that the strategies in the economic sectors recognize sustainable resource management within the general goals, but do not manage to fully elaborate the measures and commit to the operationalization of such approaches in an appropriate manner.

CHAPTER 7: INSTITUTIONS AND TRUST BUILDING

The progressive 'legalization' of the informal sector is clearly an essential requirement for its integration into society. But it is more likely to take place in a positive environment where the obstacles to entering legality are reduced to a minimum, where the costs of being legal are not prohibitive, and where there are clear benefits to becoming legal – i.e. where the public authorities are known to be (and seen to be) supporting rather than harassing the informal sector".⁹⁷

7.1. The Informal Economy and Informal Institutions (Social Norms)

Institutional theory defines institutions as cognitive, normative and regulatory structures that provide stability and meaning to social conduct (Scott, 2005). Formal institutions are codified in laws and rules, while informal institutions represent the norms, convictions and values cherished by individuals and reflect individual attitudes about what is right, and are not subject to legal sanctions. Informal institutions can be complementary to the formal institutions and they can also be in conflict with formal institutions. If there is synergy between the formal and informal institutions, the informal economy will be much smaller and citizens will comply with legislation. The reasons for non-compliance with the legislation can be found in the fact that formal rules are so complicated that citizens unintentionally do not comply with them.

Tax morale or the attitude of citizens towards payment of taxes shows how citizens see non-payment of taxes – as an acceptable or unacceptable practice. The tax morale index ranges between 1 and 10, where 1 means that tax evasion is absolutely unacceptable, while 10 means that tax evasion is absolutely justified. The value of the tax morale index for EU Member States was calculated on the basis of the Eurobarometer survey from 2013 – citizens allocated numbers from 0 to 10 to the question of whether it was acceptable to lie when paying taxes and whether there was any justification in individual cases.

The average value of the tax morale index for EU-28 countries is 2.29, which means that the citizens of the European Union consider evasion of taxes to be socially unacceptable behaviour. On the basis of the data on the participation in the informal economy and the value of this index, it was established that there is a statistically significant link between the percentage of participation in the informal economy and tax morale (William, Horodonic, 2015).

The tax morale index for Montenegro has been calculated on the basis of questions from the Survey (IPSOS, 2014) on whether it is acceptable or unacceptable not to pay taxes and contributions on salaries.

⁹⁷ ILO, 1991: pp. 35–36.

On the basis of the Survey, where more than 80% of the respondents said that tax evasion is unacceptable behaviour, and on the basis of other answers, the calculated value of the index for Montenegro is 2.73. However, in spite of the fact that failure to pay taxes and contributions is socially unacceptable, it still is a very significant practice of employers and self-employed people.

Given what the respondents said when asked about their motives for participating in the informal economy and given the understanding that a poor economic situation motivates employers not to register their employees, it is obvious that for the population that is able to work, having employment is more important, regardless of the conditions of employment, than whether taxes and contributions are paid or not. Likewise, given a certain level of mistrust in formal institutions and the fact that for 50% of undeclared employed people this is actually a question of choosing between being inactive or working in the informal economy, the situation in reality is such that the unacceptability of tax evasion does not mean that individuals will not put effort into avoiding taxes and contributions. The question of evasion also has to be observed through the lenses of the benefits that the payment of taxes brings and through the understanding of individuals of whether the funds paid in the form of taxes are spent in such a way that in the end they contribute to the wellbeing of those individuals that decide not to pay taxes.

In addition to this, more than half of the working population of Montenegro would not report informal work to the authorities. When asked about the reasons why they would not report informal work, 28% of the working population of Montenegro say that it would be unacceptable behaviour, 24% say that they think it would influence an increase in unemployment, i.e. they believe that the jobs would just disappear, while 22% think that it is the task of the institutions. Mistrust of the institutions is the answer of 10% of the working population, while 6% think that they might have problems if they reported informal work.

Thus, the failure to pay taxes and contributions is socially unacceptable for the majority of the working population in Montenegro but, if informed that there is informal work, or if hired in an informal manner, more than half of the working population of Montenegro would not report it to the inspection bodies.

Employers who have undeclared employees think that not declaring employees is common practice and that all employers have undeclared employed people. The Government also believes that large companies are particularly accepting of undeclared employment. However, the data from the Survey shows the opposite - that undeclared work is a phenomenon that characterizes mostly small companies.

The dominant belief of working individuals related to the scope of protection of employed people through the provisions of the Labour Law is that employers are in a privileged position (87% of working individuals think so), while 7% think that employed people are overprotected. On the other hand, practice and the value of the index of legal protection of employment paint a different picture. In

comparison to the countries of the European Union, even welfare countries like Sweden and Denmark, the scope of legal protection is significantly higher, while practice shows that labour disputes mostly finish in the benefit of employed people, most frequently for procedural reasons.

7.2. Regulatory Framework - Formal Institutions

“I would accept to work even for €100, just to have a permanent job and social security. Social security first, because my children will grow up and leave, and I will remain alone without anything. I did not have social security in my first job either. At first I thought – I wish I could find a job to get a salary of €400 to €500, the security is not so important. But as the years go by and my children grow up, you start thinking – who will support you if you have no pension? If you had €100 at least it would be different. Neither my husband nor I have registered employment – how shall we live in the future? It is not important how much it is, it just makes you feel more secure.” – An informally employed woman who is a beneficiary of material allowance for families.

The legal framework in the labour market that is relevant from the aspect of the informal economy is comprised of the Labour Law, laws in the field of social care and childcare, laws in the field of healthcare and tax legislation. The Labour Law defines the basic principles of regulation of contractual relations between employers and employees. Given the assumption that employers are superior to employees, particular attention is attached to the strengthening of job security and protection of employees, particularly in case of termination of employment contracts.

OECD’s research (OECD, 1999, 2004 and 2006) shows that rigid legislation in the labour market leads to a maintaining of the level of unemployment as well as higher unemployment among women, the young and elderly men. In countries that have strict labour legislation, the activity rate and employment rate are lower, while the proportion of self-employed people out of the total number of employed people is higher.

These characteristics can also be seen in the labour market of Montenegro. The labour law from 2003, although it was an improvement in some of its provisions, assumed a high level of protection of employed people. The value of the EPL index was 4.2 (on a scale of 0–6 where 0 is flexible regulation and 6 is rigid legislation).⁹⁸ The reform of labour legislation in 2008 led to an increase in flexibility, primarily through regulations that are related to the use of fixed-term contracts, so that the index of legal protection of employment was reduced by 1.7 which represented the most flexible legislation in Europe. The reform of legislation from 2011, although it did improve labour legislation in certain

⁹⁸ The OECD’s legal protection of employment index (EPL) is a weighted average of 22 different indicators that describe various aspects of fixed-term contracts and contracts for an unlimited term, as well as collective dismissals.

aspects, particularly in the field of severance payments, led to an increase in the value of the EPL index to 3.2 (MF, 2014) primarily due to a limitation on the use of fixed-term contracts.

A reduction of flexibility in the labour market in 2011, together with other factors, contributed to a gradual increase in the overall employment (by 2pp), an increase in unemployment among the young, a reduction in job security for employed people, and thereby the quality of jobs (an increasing number of employers engage employed people through agencies for temporary employment due to the constraints of fixed-term contracts), a reduction in the number of new jobs and an increase in expenditures for various measures in the labour market and social benefits.

Table 7.2.1 - Value of the EPL index⁹⁹

	Contracts for an unlimited term	Fixed-term contracts	Collective dismissals	Total EPL
Labour Law from 2011	3.2	2.3	5.0	3.2
Labour Law from 2008	1.7	0.7	4.1	1.7
Labour Law from 2003	3.2	4.0	5.0	4.1
Labour Law from 1990	3.2	4.0	5.0	4.1
Average for South-East Europe	2.1	2.9	3.7	2.7
Average for the Western Balkans	2.3	3.0	3.9	2.9
OECD average	2.1	1.8	3.0	2.1

Source: wiiw (2009), Ministry of Finance, 2014.

In addition to the Labour Law, the key pieces of legislation regulating the rights and duties of employed people include the General Collective Agreement as well as the branch and individual collective agreements. The provisions of these agreements additionally reduce flexibility, particularly when it comes to dismissals due to non-compliance with the provisions of the contract and undesirable conduct of the employed person. In such cases the employer is obliged to conduct disciplinary proceedings that look like simplified court proceedings, where there is a big possibility that the employer will make a mistake, since most employers lack the expertise for this kind of proceeding.

The Law on Social and Child Care is important for informal employment for three key reasons. The first is that it is possible for informally employed people to use the rights provided for in this law related to social assistance. Research shows that one-quarter of the beneficiaries of social assistance are informally employed. The second, very important, aspect is related to protection of women in pregnancy and childbirth. Informally employed women are not entitled to parental leave and compensation of salary on that basis, which is guaranteed in the Labour Law, while the Law on Social and Child Care

⁹⁹ Wiiw (2009) – Study on the Adjustment Capacity of Western Balkan Countries to External Shocks, Ministry of Finance (2014).

guarantees reimbursement to the employer. Thus, in the case of pregnancy and childbirth, women are mostly forced to terminate their informal employment, since they cannot use these rights.

In recent years it has been the practice of employers to register pregnant women with a view to obtaining compensation of their salary during maternity leave from the state, and then to unregister the women employees after the period of maternity leave is over. Through amendments to the Law on Social and Child Care from 2013 and strict application of the law, this practice has been significantly reduced. Through the latest amendments to the Law on Social and Child Care from 2015 an allowance for mothers was introduced which opened up an additional possibility to abuse the system. A large number of women, registered as unemployed in the Employment Office, some of them hired in the informal sector, are still able to receive benefits from both sectors – formal and informal. There are no incentives to formalize these types of arrangements, since formalization would mean a loss of relatively high amounts that are allocated for living costs, in exchange for formal engagement that in the end would not provide such long-term benefits on an individual level.

7.3. Effectiveness of Institutions

“It is not easy for employers either. Everything is on their backs – fines, inspections...; the costs are high – the leasing of premises, salaries, various duties... That is why many companies are not operating any longer.” – An informally employed man who is paid part of his salary “cash-in-hand”.

“If there was more intensive action against labour in the grey economy, all the companies would be closed down.” – An informally employed man whose entire salary is paid “cash-in-hand”.

The scale of the informal economy and undeclared work also depends on the effectiveness of the institutions as well as the belief of citizens about whether they will be treated equally in the application of the law. The efficiency of institutions also depends on how much the formal institutions correspond to the attitudes of the population.

Research shows that 58.5% of the population of working age think that companies that employ people informally will be detected. The same respondents also think that the probability that such companies will be punished is 87.6%, while they think that the probability that they will actually pay the penalty is 88.7% (IPSOS, 2015).

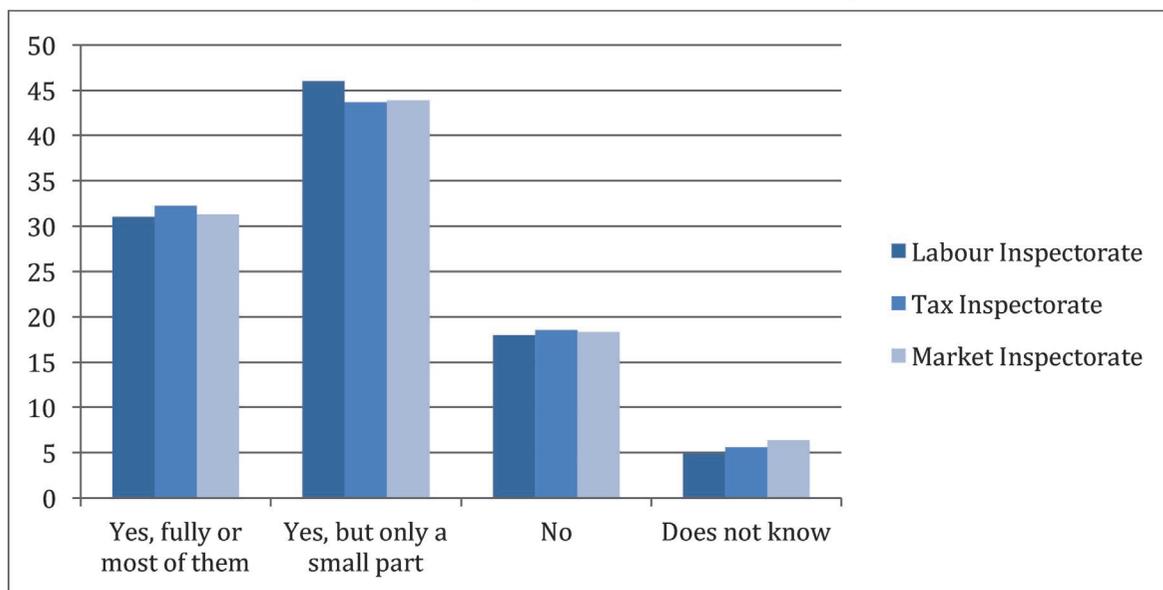
As for the assessment of the effectiveness of the labour inspection bodies in detecting and punishing undeclared labour, almost one-third of the population able to work think that undeclared work will be fully or partly detected. About 46% of respondents believe that the labour inspection bodies are

effective, while the remaining 33% do not think that the labour inspection bodies are successful in detecting undeclared labour.

Labour inspectors visited two-thirds of the respondent companies in 2014 and imposed sanctions on 20% of them, most frequently on companies with informally employed people. In half of the cases the employers were of the opinion that the penalties were appropriate; approximately one-quarter thought that the penalties were lenient, and approximately one-fifth that the penalties were too high. About 15% of employers said that they managed to avoid paying the penalty imposed by the inspectors.

Particular attention should be paid to the practice and conduct of the inspectors, in terms of their approach to the objects of the inspection and imposing or not imposing penalties. An increasing number of employees have complained about different interpretations of the legislation by the inspectorate, depending on the individual inspectors and about the large degree of discretion on the part of the inspectors.

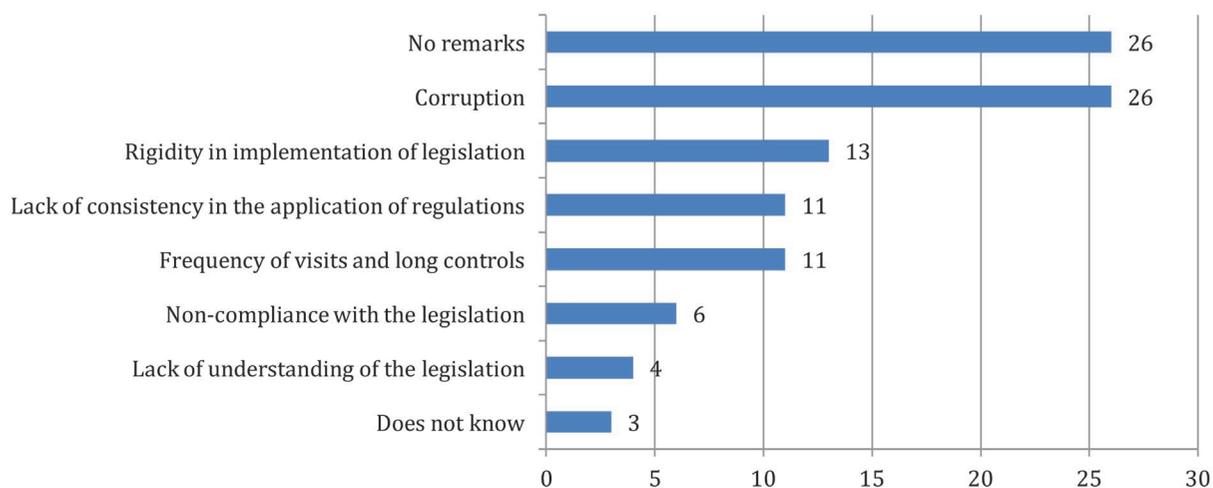
Figure 7.3.1 - Perception of the effectiveness of inspections



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

The working population has a similar perception of the effectiveness of the tax and market inspections in detecting informal work as they have of the labour inspection. However, given the mostly positive perception regarding their effectiveness in detecting informal work, only 26% of employers did not make any complaints about the work of the inspectors.

Figure 7.3.2 - Complaints by the employers in the private sector about the work of the inspection bodies



Source: IPSOS (2014), Informal Employment and the Grey Economy in Montenegro 2014.

The perception of a quarter of employers is that the inspectors are susceptible to corruption. A total of 24% of employers complain that the inspections implement legislation too strictly (13%) and inconsistently (11%), while 11% of employers think that the inspectors spend an unjustifiably long time on their audits. The problem for 6% of employers is that the legislation is not applied, while 4% of the employers think that the inspectors do not know the law.

The above results indicate the perception of the population that the inspections (labour, tax and market inspections) have the capacity to detect informal employment and informal activities, however the expectations from successful audits are significantly lower. Also, when the work of the inspections in Montenegro and their plans of work and reports are analysed, the impression is that the emphasis is on the strategy of “intimidation” and punishment, as well as the fact that insufficient attention is paid to education of the relevant entities. Education of the relevant entities becomes particularly important in an environment of intensive regulatory activity, as is the case with Montenegro, and at a time of amendments being made to legislation with a view to ensuring harmonization with European legislation.

7.4. Strengthening Effectiveness and Trust in the Institutions

Strengthening the effectiveness of institutions and strengthening trust in the institutions in practice means the reduction of differences between formal and informal institutions. The practice recorded globally is that the activities towards the improvement of compliance with the legislation can be seen by the population in overly strict rules, definition of procedures, centralized control and supervision structures with a low level of trust and dedication, and a poor approach - “cops and robbers” (William, Horodonic, 2015).¹⁰⁰ Given the limited reach of such a policy, reflected in the maintaining and negligible reduction in the scale of informality in economies worldwide, the recommendation is that the state’s approach has to change significantly and that an approach has to be adopted where a culture of trust, as well as a high level of dedication and alignment with the beliefs of the individuals, is cultivated.

Since the scale of the informal economy can be reduced only through a reduction of the asymmetry between formal and informal institutions, changes have to be made within both formal and informal institutions. Changes in informal institutions i.e. in the attitudes and perception of citizens about the benefits and threats of informal work, can be achieved through the following:

- An increase in the awareness about the consequences of the lack of formal working history, the lack of benefits and the lack of formal/informal work
- Tax education with a view to harmonizing the value with the formal rules and promotion of self-regulation
- Improvement of policies, with a view to ensuring better planning, execution of the budget and measurement of achieved results, as well as an increase in the transparency of public spending and visualisation of the budget

The population’s tax morale will not improve if trust in institutions is low and if belief in the existence of corruption in the public sector is widespread. Modernization of the government and governance, promotion of responsibility for results, as well as a change in the style of governance, are required both in terms of managing public finances and in terms of ensuring public services, particularly those that are financed directly from the taxation of labour (health insurance and insurance from unemployment).

It is important that citizens perceive the system as just, and therefore the following is required (Williams, Horodnic, 2015):

- An improvement in procedural justice - the tax authorities should treat citizens and businesses with respect and impartially, and responsibly focus on a service-oriented approach

¹⁰⁰ Williams, C., Horodnic, I. (2015) “Marginalisation and participation in the informal economy in Central and Eastern European nations”, *Post-Communist Economies*, pp. 153–169.

- Ensuring procedural regularity - individuals have to be convinced that the amount of tax they pay is fair in comparison to what others pay
- Establishing of redistributive justice, in such a way that citizens are convinced that, for the taxes they pay, they get an appropriate quality of service from the public sector

In addition to the above listed changes that are related to how citizens perceive whether paying or not paying taxes and contributions is justified, and in addition to changes in the improvement of the manner and style of the managing institutions, changes are required in the formal rules as well. As theoretical and empirical findings show, the legal framework in the labour market is too rigid for an economy like Montenegro's. In addition to this, the scope of the tax burden is too high in comparison to more developed countries that have much higher spending on social care. The tax burden is perceived by owners and directors of companies as one of the most serious problems and motives for undeclared labour. They usually do not perceive labour legislation as such a serious problem because they mostly do not comply with it, since the perception is that the inspections are insufficiently effective in the detection of informal work.

Based on the principle "less is more", the framework of rights from the Labour Law should be harmonized in such a way as to promote the key rights of employed people and to move the focus from job security to employment security, i.e. to increase flexibility in the labour market and mobility between jobs and employers. Higher mobility between jobs means enhancing human capital through enhancing the skills and competences of employed people. Attachment to one job mostly means stagnation and an inability to adapt to changing circumstances, which happened to a large number of employed people in Montenegro when the transition process started. In the pre-transition period, which is not a feature of transition economies only, the probability that employees go into retirement from the company where they started working was high. Today such practice is inconceivable.

CHAPTER 8: POLICY CHALLENGES – TRANSITION FROM INFORMAL TO FORMAL EMPLOYMENT

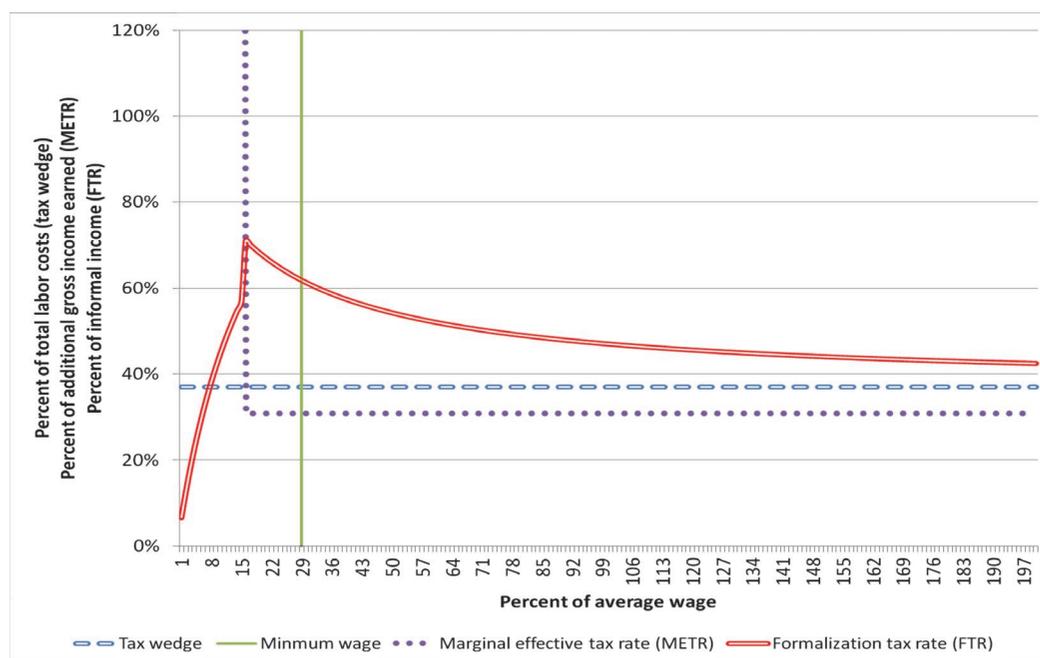
*“A hard walnut is a peculiar fruit.
You’ll not break it, but it will break your teeth.”*

Petar II Petrović Njegoš

8.1. Legal and Institutional Constraints (Tax-Benefit Model)

The informal economy in Montenegro, in spite all of the activities aimed at its reduction, still makes up a significant share both of the labour market and within the overall economic activities. Particularly interesting is the passive attitude of people engaged in the informal economy who are not doing anything to change their status. The number of people reporting non-compliance is very small. The assessment that institutions are ineffective in their efforts to solve this issue can offer only part of the explanation. Another part of the explanation may lie in the incentives for formalization i.e. the relationship between the benefits that individuals enjoy as informally employed people and the consequences that formalization will have for their benefits and costs.

Figure 8.1.1 – Disincentives for work (employed couple with two children)



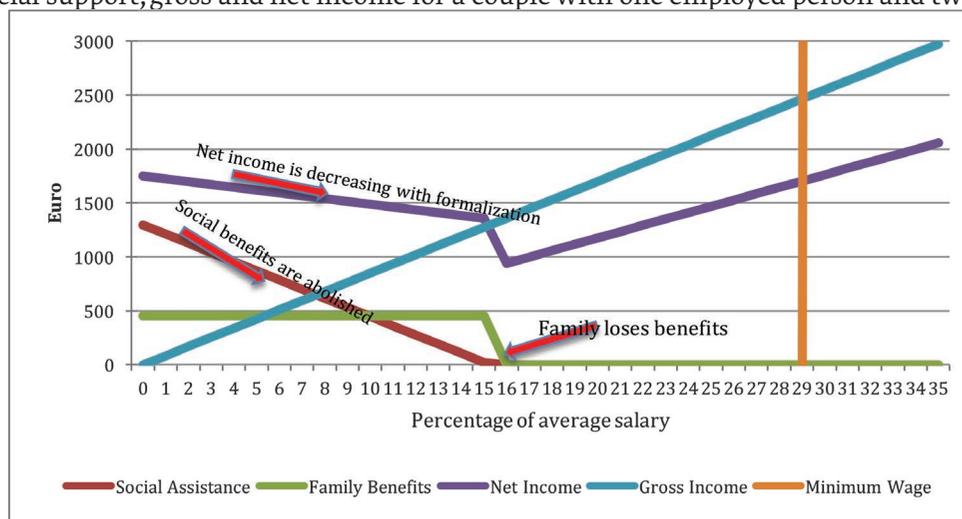
Source: World Bank, on the basis of the OECD Tax and Benefit Model for Montenegro, 2011.

The OECD tax-benefit model was prepared for Montenegro by the World Bank team.¹⁰¹ The model analyses how the tax system and the social care system influence activities in the labour market and formalization of employment, i.e. whether it is more profitable to be informally employed and enjoy the right to social support than to have formalized employment, and whether it is more profitable to be inactive and receive social support than to have formal employment, given the profile of the beneficiaries of social support. Analysis of the model shows that there are negative incentives for formalization that have come into existence as a consequence of the design of the system of social support and family benefits. The design of the system is such that the beneficiaries of social support are not interested in working at all, or if they do work it is not attractive for them to formalize their work, since for every euro that a beneficiary of social support earns in Montenegro, he/she loses more than one euro in the form of social support. This results in a marginal effective tax rate (METR) that is higher than 100% (Figure 8.1.1). Material allowance for families is not taken away only from those families that earn less than 15% of the average salary, while for everyone who earns more than that, this right is absolutely abolished.

People that are able to work are entitled to receive the material allowance for families if they have dependent children, if they do not have formal employment and if they meet the criteria related to property. As beneficiaries of material allowance for families, the families receive not only the amount of this allowance, but also a special allowance for children, subsidies for electricity bills, discounts for monthly kindergarten fees, textbooks free of charge, health insurance, administrative and other services free of charge.

Figure 8.1.2 – Formal jobs and incomes from social support

(Annual social support, gross and net income for a couple with one employed person and two children, €)



Source: World Bank, on the basis of the OECD Tax and Benefit Model for Montenegro, 2011.

101 Technical assistance project "Removing Disincentives for Work", experts Jan Rutkowski, Johannes Koettl, Boryana Gotcheva, Zoran Anušić.

According to the findings, the most significant disincentive for formalization exists for people with poorly paid jobs, particularly for young couples with two children. The design of the system of social and family benefits makes poorly paid jobs (so-called mini and midi jobs) economically unprofitable. The effects of the disincentives for formalization and activation were measured through the tax rate of formalization, which measures the amount of net income that an individual will lose if he/she chooses to formalize his/her activity, in terms of net salary and other social benefits, if he uses them. In Montenegro the tax rate of formalization is as much as 70% for people with low salaries, or in the case of an employed couple with two children, accepting a job with half the number of working hours can effectively reduce the net income by 70%.

The key issues for the tax-benefit model are the activity rate and the informality rate in the labour market. Empirical analyses of the new EU Member States show that high disincentives for informal work, measured by the tax rate of formalization and METR, are associated with a larger volume of informal employment.

In addition to the design of the system itself, legislation in Montenegro contains other constraints on formal work. Before 2008 retirees who wanted to increase their income were not in a position to do so through any kind of engagement in the formal economy. It was the same for students who were recipients of family pensions before 2010. Montenegrin legislation contains another anomaly of this kind. Students whose education process is financed by the state and have a student loan or any form of scholarship (accommodation in a dormitory, the right to use the student canteen under favourable conditions, etc.) lose their right to those finances if they find formal employment during the season. This policy and provisions in the legislation stimulate work within the informal sector and have a negative impact on work activity.

8.2. Implemented Policies for a Reduction of Informality

In the 1990s, due to negative social and economic developments, the informal economy and informal employment expanded. The informal economy became the subject of studies in the late 1990s and early 2000s. At about the same time, national policies started dealing with this issue more seriously for the first time and undertook measures that were supposed to be aimed at reducing various forms of the informal economy, including the fight against informal employment and the informal economy in the labour market. The institutional framework in combating the informal economy consisted of various institutions whose strategic goals were directed towards solving this problem. The key bodies in charge of implementing these policies include: the Ministry of Labour and Social Welfare; the Ministry of Finance; the Employment Office; the Administration for Inspection Affairs (Labour Inspectorate); the Tax Administration; and the Ministry of the Interior.

8.2.1. Initiatives in Combating the Informal Economy and Informal Employment

Transferring the informal economy into the formal sector requires not only determination, but also very energetic reforms. In that respect, the reforms include not only adoption of the laws that are appropriate for the market economy, but also their implementation.

With the aim of the overall social and economic development of the country, the Government of Montenegro adopted the Economic Reform Agenda for the five-year period 2002-2007. According to this document, which was primarily focused on development of entrepreneurship and elimination of the informal economy in the field of labour and new employment, the programme “Legalizing Existing Jobs and Creating New Jobs”¹⁰² was adopted. The programme defined the expected effects, including the envisaged legalization of about 20,000 illegal employments already in the first 12 months, as well as the development of a culture of legal employment with almost complete elimination of informal work in a period of four years. The programme also envisaged the achievement of economic growth that would ensure the creation of 5,000 new jobs a year. This goal was not achieved, although certain results were visible, particularly regarding the number of registered employed people. This was partly a consequence of the legalization of a large number of jobs on the basis of the Decree on tax reliefs for new employment that motivated employers to declare some of their employees that had not been declared before and to employ new workers.

In 2005 the new programme “Incentives for New Employment” was launched. This programme represented a continuation and innovation of the programme “Legalizing Existing Jobs and Creating New Jobs”. The programme defined the results expected for 2005. They included development of a culture of legal employment with a gradual solution of the complex problem of the informal economy and undeclared work. As in the case of the previous programme, certain progress was been achieved in reducing the number of unemployed people and achieving higher economic growth, but the problems related to informal employment still persisted.

By 2011 the policies on combating the informal economy were mostly ineffective because the process of implementation was being limited by numerous problems.

8.2.2. Intensification of the Work on Combating the Informal Economy - a Systemic Approach

The Ministry of Finance and the institutions under its umbrella did the most of the work and had the most important initiatives in 2011 in the process of combating the informal economy. In addition to working on ensuring an adequate tax system that would be attractive for investors and for new employment, efforts were invested into additional simplification of numerous pieces of legislation. The solutions that enabled better liquidity were improved (payment of corporate profit tax in instalments,

¹⁰² The programme was adopted on 20 March 2003.

reprogramming of tax debts and delayed payment of customs debts, etc.). Along with these activities, campaigns aimed at combating the informal economy were also intensified.

Still, most of the policies in combating the informal economy were not integrated and the responsibilities were mixed and the effects hard to identify. Concretization of the measures for combating the informal economy started in late 2011 and early 2012. Proposed by the Ministry of Finance, the document 'Information about measures to combat the informal economy for 2012' was adopted. On that basis a coordination team for monitoring the implementation of the measures for combating the informal economy was formed and it defined the Operation Plan for combating the informal economy for 2012. This initiative was launched with a view to ensuring better coordination, i.e. a systemic approach to intensifying the combating of the informal economy in all areas. The Operation Plan envisaged the activities in the four areas that were recognized as carrying the highest risk from the aspect of the informal economy: control of turnover of excise product, recorded turnover in retail, the labour market and unregistered legal and physical entities.

The measures envisaged in this plan, with the improved tax system, i.e. simplification of legislation and low tax rates, led to better efficiency of the entire system from the aspect of the administration and paying of taxes. More concrete and more intensive work by the relevant authorities contributed to better communication and a faster flow of information, while in practice numerous results were produced that were aimed at improving fiscal discipline. This primarily refers to a stricter policy of sanctions (closing down premises and prohibiting operation).

According to the Report on the implementation of measures from the Operation Plan for combating the informal economy for 2012, in the field of combating the informal economy in the labour market, the effects of the work of the Labour Inspectorate were visible through regulation of formal employment for a large number of people, higher amounts paid on contributions for compulsory social insurance, the signing of employment contracts for an unlimited term for several hundreds of employed people that were found to be working without an employment contract. In addition to inspection bodies and their activities, the Misdemeanour Panel of Montenegro gave its contribution to the implementation of the measures for combating the informal economy: they started numerous initiatives for imposing stricter penalties for those that violate the legislation, organized training within the inspection services for people that file applications, they worked on improvements to legal solutions that were not in line with the penalty provisions of the Law on Misdemeanours.

8.2.3. Action Plans for Combating the Informal Economy

In 2012 the work on defining measures for combating the informal economy was intensified. Thus, in 2012 a coordination body - the Working Group for Combating the Grey Economy - was established and it defines a set of measures for combating the informal economy in the action plan for every year,

including the measures necessary for strengthening the institutional capacities and human resources of the state administration bodies responsible for auditing and collection of revenues. This activity was within the competencies of the Ministry of Finance, but the working group for developing the set of proposed measures included representatives of other state bodies and also the representatives of social partners and the economy. The work of this group was the basis for defining the Action Plan for combating the informal economy for 2013, which envisaged the activities, relevant institutions and goals of each individual activity aimed at various fields, including the labour market. In the field of institutional strengthening, in early 2013 the Commission for Combating the Grey Economy was established.¹⁰³

The Action Plan for combating the grey economy for 2013 (and every plan after that) envisaged zero tolerance of the grey economy and paid particular attention to identifying the problems and deficiencies that create room for irregular operations in the field of legal and technical constraints for more efficient implementation of inspection supervision and for defining the model for their solution. Implementation also started for the measures that were agreed and that referred primarily to establishment of various working groups (to increase efficiency in the collection of the residence fee, analysis of the current legislation, education of staff employed in the inspection services, combating the informal economy in the labour market, improving coordination and cooperation between state bodies, etc.). The results of the more intensive work on combating the informal economy in 2013 (together with other policies as a set of urgent measures of fiscal alignment) were visible through improved fiscal discipline and a significant increase in public revenues in comparison to the previous year.¹⁰⁴

On the basis of the Action Plan for 2014, the system measures continued to be undertaken with a view to further combating the informal economy. In 2014 a media campaign was intensified at the national level. Its goal was the strengthening of the fiscal discipline of all taxpayers and it was aimed at motivating citizens and the economy to behave responsibly, raising awareness of the negative consequences of the informal economy both for citizens and for companies that operate legally and have to face unfair competition. Still, the key challenges remained compliance with the principles of zero tolerance and an unselective approach in the implementation of all measures, as well as the possibility of implementing certain measures, i.e. the existence of adequate and sufficient capacities.

8.2.4. Raising Public Awareness of the Informal Economy - Public Campaigns

In addition to the activities aimed at improving the legislative framework and capacity of institutions in combating the informal economy, in the recent period significant activities have been undertaken with a view to raising awareness and improving the knowledge of citizens about the grey economy.

¹⁰³ In addition to representatives of the relevant state bodies, this Commission also included representatives of social partners, the economy, the Parliament of Montenegro and the State Prosecution Service.

¹⁰⁴ In 2013 budget revenues increased by €117.5 million or 10.4% in comparison to the level in 2012.

To that end, during 2011, on the initiative of the Ministry of Finance, the campaign “VAT is your money” was conducted. It was aimed at reducing the informal economy in the field of issuing fiscal receipts through intensified inspection controls and public support for the campaign. In 2011 visible results were recorded in terms of an increase in revenues from VAT and an increase in the number of taxpayers and VAT payers.

In 2013 the Government of Montenegro started implementing the project “Involving citizens in combating the grey economy” which is being implemented in cooperation with the Faculty of Electrical Engineering from Podgorica, UNDP and with the support of the British Embassy in Podgorica. This project ensured easy engagement by citizens in combating the informal economy through the mobile application “Be responsible” that was used by more than 3,500 users. The campaign that was conducted within this project led to an increase in awareness about the negative sides of the informal economy. Primarily the campaign “Be responsible! It’s up to you! The grey economy at 0%” that was conducted in the period from 2013 to the end of 2014, resulted in the significant engagement of citizens in combating the informal economy. In this period the citizens lodged about 5,000 reports highlighting informal employment, the failure to issue fiscal receipts and other irregularities in the market. As a result, on the basis of imposed penalties, about €550,000 was collected.

Along with this campaign, the Ministry of Finance started the campaign “Speak up! Uncover the grey economy!” in order to encourage an active role of citizens in the process of combating the informal economy, primarily through pointing out the problem of failing to issue fiscal receipts, avoiding paying excise duties, illegal employment, illegal construction and other irregularities. The campaign facilitated communication between citizens and relevant services by providing a free telephone number to the Tax Administration.

8.3. The Existing System of Incentives for Formalization¹⁰⁵

Although the scale of the informal economy is significant, Montenegro does not have any system of incentives that are focused on the formalization of economic activities. However, there are a number of other measures in the field of employment policy and tax policy that can be at the same time seen as measures for formalization.

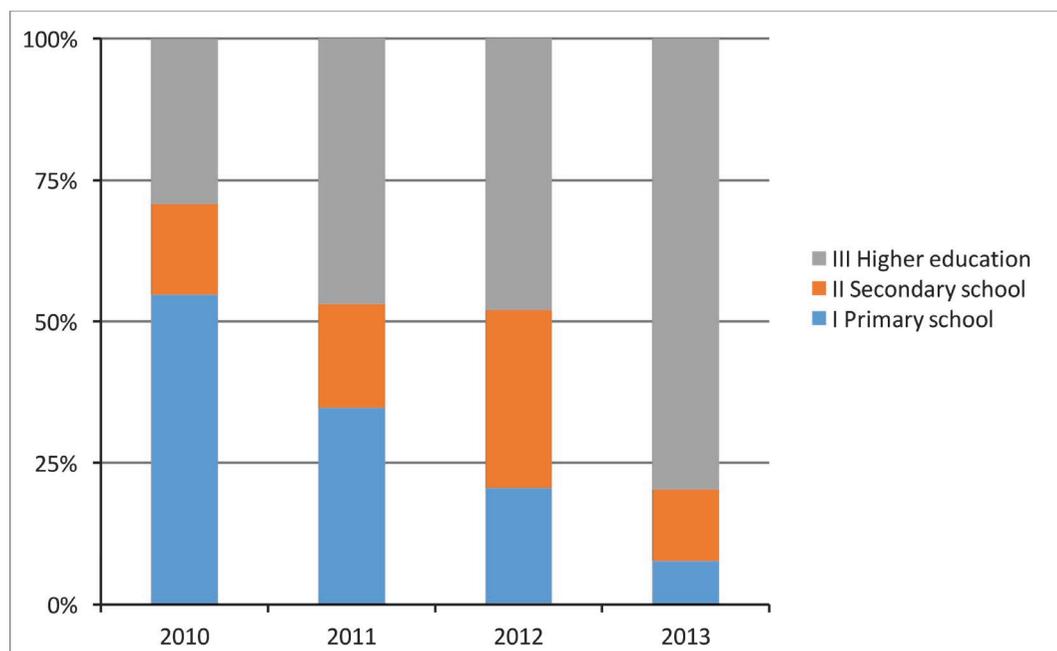
Higher spending on active policies in the labour market should support formalization on the side of labour supply and on the side of demand for labour. If coordinated with formal companies, active policies like subsidies for new jobs, or training in the workplace could reduce costs of employment and training and thus facilitate employment in the formal sector. On the supply side, active policies increase the flows from unemployment into formal employment (Hazans, 2011). Empirical findings about the effects of active measures on employability produce various different results and primarily depend on the design of the active measures (Card et al, 2009).

¹⁰⁵ Taken from M. Arandarenko, V. Simović (2015) – Enabling the transition to formal employment in Montenegro.

In Montenegro, overall spending on the active policies was about 0.5% of GDP before 2011, when, as part of the measures of fiscal savings, this spending was cut in half. After this reduction, the spending on active policies in 2012 and 2013 fell to 0.1% of GDP. However, in 2013 the programme for professional training of university graduates started. It included about 4,000 participants and cost annually almost €10 million. This led to a situation where the spending on active measures in the labour market reached a level of 0.5% GDP again. This level of spending on active measures is high if we compare it to that of other countries in the region, although it is slightly lower than the EU average. However, the structure of spending by type of programme and characteristics of the participants changed significantly, since university graduates make up 80% of the total number of beneficiaries of active measures (Figure 8.2.2).

Since the majority of the beneficiaries of the active policy measures in 2013 belong to the education group with the lowest probability of being engaged informally, we can conclude that the impact of the existing mix of active policy measures on the reduction of informality is lower than it was pre-2011. This effect is alleviated by the fact that the beneficiaries of the programme are young people without any work experience.

Figure 8.3.1 - Spending within active policy in the labour market on target groups by level of education in Montenegro 2010-2013 (% of total spending)



Source: Arandarenko, 2014

Tax subsidies for employers that employ certain categories of employees are in essence a tax credit for employees who employ first-time employees from certain groups. Employers are exempted from paying income tax and contributions for compulsory social insurance. The employer can use this subsidy if he employs a person registered in the Employment Office as unemployed, if this person is older than 40, is a member of RAE population, has been employed for more than 5 years, has finished his/her internship period and is to be employed for an unlimited term, as a seasonal worker, is the beneficiary of the allowance for unemployed people with over 25 years of service, and for other cases.

Through a special programme, the Government subsidizes contributions for social insurance for registered farmers. Registered farmers are obliged to pay contributions for social insurance on a fixed basis of 20% of the average salary, while the remaining contribution of 40% of the average salary - which is currently the amount of the minimum wage - is subsidized by the state.

The new Law on Social and Child Care (2013) envisages stronger cooperation between the Employment Office and social welfare centres with a view to activating beneficiaries of the material allowance for families. These beneficiaries who are able to work have to be registered in the Employment Office and accept the offer of a job, training, retraining and additional training if they do not want to lose the right to material allowance for families for at least a year.

8.4. Examples of Good Practice

According to the study “The Grey Economy in Europe” from 2013, about half of the measures in combating the informal economy refer to undeclared work and informal employment. Transferring informal work into formal flows is one of the key challenges for many countries and therefore the planning of activities aimed at reducing undeclared work is of extremely great importance, particularly for those sectors where this phenomenon is most emphasized (construction, agriculture, trade and tourism). To that end, countries have defined strategies, directions and policies for combating the informal economy, where the most important measures are related to tax reform, simplification of the procedures for registering employed people and procedures for collection of taxes, as well as various campaigns aimed at raising the awareness and tax morale of citizens.

Tax reform and the introduction of proportionate taxation of income have led to a reduction in tax evasion in a number of countries. One example is Russia, where after a proportionate tax rate on income was introduced in 2001, tax evasion declined not only because of the change in the tax rate, but also because of the simplification of the procedure for reporting and paying taxes. Such a positive example can also be found in the case of tax reform in Estonia, which introduced proportionate taxation in 1994 with the same income tax rate for the income of citizens and the profit of companies. Similar positive examples of the reduction of informal work can be found in the Czech Republic and Slovakia¹⁰⁶. Thanks

106 Ibid.

to the measures implemented in the field of tax policy, the Czech Republic reduced informal work to 9-10% of GDP in 2006/2007, which secured it a position among those countries with the lowest informal employment in Europe. Similar reform moves were made in Montenegro and they were successful.

Reducing administrative barriers and simplifying the procedures for registering workers and paying taxes can be important measures for the reduction of informal employment. A successful example of the simplification of the process of declaring and registering employees can be found in Hungary and Belgium. In Hungary, employers can use simplified employment contracts for seasonal workers and register them electronically or by telephone message. This reduces registration costs. In that case, taxes are paid on a daily basis. This measure produced positive results - in the period from August to December 2012, a total of 12.5 million working days were registered in this way.¹⁰⁷ In Belgium they introduced a system of vouchers, where the vouchers can be bought from registered companies and used to pay domestic workers. Each voucher is worth one hour of work. This measure had positive results in the process of combating informal employment. According to the 2013 study “Labour Inspection Strategies for Combating Undeclared Work in Europe” by the International Labour Organization, in the period 2004-2012 the number of users of vouchers increased by 120,247 to reach 857,471,¹⁰⁸.

A number of preventive measures and incentives were conducted in European countries with a view to reducing informal employment. In France, employers that employ less than 20 employees are allowed to employ new workers for a trial period of two years. During that period the company can terminate the employment contract with any of them at any time for no specific reason. Such measures of reducing undeclared work also include the option for unemployed people in the UK to test their business ideas for self-employment for a certain period of time without losing their allowance for unemployed people. Similarly, in Belgium, the long-term unemployed can work for a certain number of hours per year in paid jobs ensured by local bureaus of labour while keeping their allowance for unemployed people.

Significant positive results were produced by campaigns and activities of raising awareness and the tax morale of companies, employed people and other citizens, as well as by information centres and web portals. For example, in Poland materials were published about informal employment, and seminars were organized on the subject of informal employment. A similar approach to informing citizens was used in the Republic of Ireland. In France the owners of construction companies are explained all the requirements of the law when they apply to obtain a licence to work and set up a business. This was done to reduce the level of informal employment. In Spain there are campaigns for declaring seasonal employment in agriculture. Similar campaigns were implemented in other EU countries, particularly in those sectors where informal employment and undeclared work are most frequent.

107 Labour Inspection and Undeclared Work in the EU (2013), International Labour Organization.

108 Ibid

The study “The Grey Economy in Europe” from 2013 notes that countries that have a higher level of electronic payments have a lower level of informal economy. Including banks and payment by cards contributes to the transparency of transactions and hinders activities in the informal economy. If we take a look at the countries of the European Union, we can see that those with a higher level of electronic payments, like the UK and Scandinavian countries, have a lower level of informal economy than Bulgaria, Romania or Greece that have a lower volume of transactions through electronic payments. The findings of this study show that an increase in the volume of electronic payments by about 10% for four consecutive years led to a 5% reduction in the scale of the informal economy.

CHAPTER 9: CONCLUSIONS AND RECOMMENDATIONS

The concept of work and that of the workplace has significantly changed, particularly with the development of technology. There are ever fewer jobs that are tied to the office and traditional ways of organizing work. Taking care of household members, children and the elderly, as a form of unpaid and statistically invisible work is underestimated from the aspect of its influence and importance for human development. Work and jobs that will be sustainable, as well as the green economy, have to be increasingly in the focus of decision-makers, as well as in policies for the reorganization of work in such a way that they enrich human development (Jahan, 2015).

Economic development has changed the scope and character of work. Physical and national borders are less and less recognized by labour, particularly intellectual labour. Work is becoming increasingly international and personalized. It is enough to have a computer connected to the Internet to be able to obtain access to numerous databases and potential purchasers of your intellectual services. The transfer of knowledge is increasingly simple and invisible, and the same can be said for the state registration of labour and for the payment of taxes.

Many people are afraid that new technologies, the computer revolution, innovation and robotics will reduce the demand for human labour and that it will lead to a significant loss in jobs, a decline in incomes and stronger inequalities. It is currently evident that a certain number of jobs are disappearing. It is less evident which new ones will appear in the labour market. Each technological revolution in the past came together with a fear of the job losses, and after each of them new work and jobs were generated that, as a rule, were more “intellectual” and more human.

We are entering a new era - the era of technological change, digitalization and robotics that will be applied and used in literally every sphere of human life. These significant changes will completely change the paradigm of work and jobs. The entire system will have to adapt, starting from its educational, economic, social and regulatory parts, so that human lives and human work can be achieved in the era of the fourth industrial revolution. Furthermore, these changes are needed at the national level so that the citizens of Montenegro, their work and the entire economy can be more productive and competitive.

From the perspective of human development, the relevant concept is work and not jobs or employment. Therefore the global Human Development Report for 2015 focuses precisely on work. Adoption of the ILO Declaration from Philadelphia in 1994, which emphasizes that work is not goods, was the cornerstone for a different understanding of work and an emphasis on human rights in relation to the treatment of employed people.

Decision-makers at the national level are faced with a tough challenge. The most important issue is creating working conditions that will function to the benefit of human development. More opportunities for work and living decently from the fruit of one's labour should be at the heart of all development strategies and policies. In countries where the working engagement of the population is historically at a low level, as in Montenegro, this is a systemic issue that requires deep changes and time.

A high level of informal work, which is also one of the features of the Montenegrin labour market, emphasizes the need to develop an institutional environment that will provide incentives to formalize work in the informal sector. This is why the imperative is the state's duty to provide high-quality services to all its citizens, and particularly to those that finance the state functions with part of their income from work. In such a way, citizens will feel the benefits of the formalization of their work. At the same time, governments should reduce the burden and constraints of formalization, regardless of whether they are regulatory or fiscal. In addition to the need to reform existing legislation, it is even more important not to adopt any new legislation that will create negative incentives for formal work. The existing and new legislation should be particularly analysed from the point of view of incentives for formal employment and work in the informal sector.

9.1. Conclusions and Recommendations

The grey economy and informal work are deeply rooted in the Montenegrin social and economic system. Although official statistics are non-existent,¹⁰⁹ using several methodologies we can obtain data that suggests that the level of fully or partially informally employed people in Montenegro has been more or less stable over the last 10 years and that it is at a level of about one-third of the total number of employed people. The measures and activities implemented in the recent past to combat informal employment have not had any significant impact on this phenomenon. Instead of short-term individual measures, the situation requires consistent systemic changes and long-term dedication to their application to influence the causes of informal employment.

Given the profile of the informal sector in Montenegro, particularly the fact that the informal sector is predominantly made up of self-employed people, it is clear that the overall business environment has certain deficiencies and contradictory features. Formalization, mainly focused on repression, would lead to a reduction in informal work, but it would also lead to a reduction in total work and economic activity, and to increased poverty.¹¹⁰ This kind of policy would be particularly dangerous in countries

¹⁰⁹ As stated above, there is no definition of informal employment that would be generally accepted, and the legislation and methodologies used by state institutions in Montenegro are not based on a single definition of informal employment. One of the important technical recommendations of this report is to design and implement methodology and a definition of informal employment that would be used by the relevant state bodies for the purpose of statistics.

¹¹⁰ Although engagement in the informal economy is not a desirable way to be engaged as an individual, informal activities decrease inactivity and unemployment among the active working population. This fact is particularly important since around 70% of undeclared employed people in Montenegro are undeclared self-employed people, which points to the development of small-scale entrepreneurship within the informal sector.

where the working engagement of the population is low, as is the case with Montenegro.¹¹¹ That is why, in formulating an adequate policy for the reduction of the scale of undeclared work, decision-makers should carefully design measures that will ensure a less painful transfer from undeclared to declared employment.

Broadly speaking, from the aspect of human development, the most desirable option is to generate new jobs and to make them of as high a quality as possible. However, high-quality jobs do not depend on the good will of any person, not even of decision-makers or economic entities.¹¹² High-quality jobs require a conducive, competitive, stable and predictable institutional system and time. If we waited only for high-quality new jobs and if we insisted on formalization through repression, a large number of informally employed people would only become inactive. That would contribute neither to a reduction in poverty, nor to budget revenues, nor to human development.

Therefore the policy of formalization has to be focused on long-term measures that are related to:

- Improvement of the business environment and improvement of the quality of public-sector services, to generate new and higher-quality jobs
- A change to the “wrong” incentives in the system, so that those who work informally can feel the benefits of formalization
- More efficient work of the inspection bodies
- Promotion of the same rules for everyone, to strengthen trust

Starting from the above, but primarily from the reasons and motives for informal work in Montenegro, we can define several (both general and specific) recommendations whose implementation would lead to formalization of work, and to overcoming exclusion and marginalization. The recommendations refer to reform of and improvements to:

- The education system
- The healthcare system
- The social care system
- The taxation system

¹¹¹ From the perspective of formalization, particular attention should be given to the hypothetical case where there is no income from informal employment, since the poverty risk rate would be much higher. If individuals lost their income from unregistered work, the poverty risk rate would be 30.3% instead of 19.3% (an increase of 57%), while an additional loss of income for employed people that have only a part of their taxes and contributions paid would increase the poverty risk rate to 33.6%. Subtracting the income from informal employment would have a much more negative effect on the growth of the poverty risk rate than if social transfers were subtracted.

¹¹² The concept of labour and definition of labour are undergoing dynamic changes. In the future, traditional work tied to the office or production plant will decrease. Technology has enabled us to work anywhere and has made monitoring and recording work and collecting taxes and other liabilities more difficult. That is why traditional employment strategies and approaches to employment policies do not produce results any more.

- The regulatory system with an emphasis on regulations in the labour market
- The public sector
- The work and conduct of the inspection and misdemeanour bodies
- The culture of (mis)trust

The education system should be inclusive, high-quality and efficient

Education is of crucial importance. The Survey of informal employment in Montenegro confirms the general rule that higher education levels are connected to a lower inclination to be engaged in the informal economy. However, it is not sufficient only to increase the enrolment and graduation rates. Systemic measures have to be defined in order to increase the quality of education and its links with current and future needs in the labour market.

An increase in the coverage, degree and quality of education will lead to improvement in the quality of jobs in both the formal and informal sectors. That is why future reform of the education system in Montenegro is one of the key system issues for the formalization of employment.

Digital transformation of society and work does not recognize borders. Work in a digital society is not connected to the place where you live. The whole world has become a “global factory” - we live in one country, while our employer lives in another, while the buyer of our services lives in a third country. This means that, regardless of national economic circumstances and prospects and regardless of the number and quality of jobs, everyone can work, provided they have the required knowledge and skills. Furthermore, continuous learning and adaptation of knowledge and skills to the needs of the 21st century is needed today. This is why education is the key, not as a preparation for a certain profession or job, but as a preparation for uncertain and unpredictable economic circumstances.

In that context, reform of the education system should emphasize understanding, (critical) thinking, practical knowledge and skills, development of creativity and innovation, so that work and entrepreneurship can come as a consequence of education. The change in philosophy, methods, manners and practical transfer of knowledge is needed from the very first steps - from the family and preschool education. This is a long-term challenge also from the aspect of the need to prepare the Montenegrin economy for increasingly competitive international competition. Education is also of decisive importance for social mobility and for poverty reduction, and that is why it should be affirmed from this aspect as well.

Within the reform of education but also due to the urgent need to reduce the problems of youth unemployment and informal employment, it is necessary to consider the option of implementing the model of so-called dual education that includes the acquisition of practical working experience during schooling and studies, using the model of successful examples from the European Union.

Health care should be more accessible, of a higher quality and more effective

From the perspective of human capital development, a lack of health insurance and of appropriate health care poses a significant challenge for policy creators. Health care, improvement of the quality of services of the healthcare system and particularly promotion of health and healthy lifestyles and health and safety at work contribute to the enhancement of human capital and lead to a reduction in informal employment.

Access to the services of the health system is not a serious problem for informally employed people in Montenegro. Among formally and informally employed people, the lack of access to health insurance is listed as low as fifth on the list of the greatest disadvantages of working in the grey economy. The reason is the fact that there are numerous modalities and ways in which health care can be ensured, regardless of the form of employment.¹¹³ However, in spite of these opportunities, there are some groups that are still not covered by the healthcare system, e.g. farmers, that do their work primarily and predominantly to ensure their own subsistence, and rarely for the market.¹¹⁴ Their exclusion, and in some case also their distance, make their position particularly vulnerable. This group and other marginalized people deserve particular attention, and conditions should be created for their inclusion into the healthcare system.

In addition to this, in Montenegro no difference is made in the level of coverage by health services between people who pay contributions for health insurance and those who do not, but are insured on some other basis. There is also no difference in treatment depending on the amount of contributions that are paid. Thus, there is no motivation to pay full amounts of contributions for health insurance, or to pay “additional” contributions to be able to use a “higher” level of health care. Montenegro should consider the option of implementing a healthcare system that will partly depend on the amount of contributions paid i.e. that will make it possible to pay additional amounts as a contribution that will enable the insured individuals can use higher levels of health insurance.

In general, for all insured people in Montenegro, the quality of the provided services is a more serious challenge than access to the health system. That is a significant determinant/constraint for human development. Independently and in cooperation with the private sector, the state should provide higher-quality and less expensive health care. High-quality health care is the key for improving the quality of life, but also for improving the competitiveness of the economy and its productivity.

113 It can be ensured in several ways – through payment of contributions (formally employed people), insurance through a household member (parents, in the case of children who are minors, and spouses, in the case of unemployed people and through obtaining health insurance as a beneficiary of some of the social care programmes – through retiring, using social assistance or registration as an unemployed person.

114 This problem is recognized and partly alleviated through the Decree of the facilities for paying contributions for insurance of farmers. It envisages the participation of the state in paying contributions for farmers.

Incentives for formalization within the social care system

The tax-benefit model prepared for Montenegro by the World Bank,¹¹⁵ analyses how the tax system and the social care system influence activities in the labour market and formalization of employment. The model analyses whether it is more profitable to be informally employed and to enjoy the right to social support than to have formalized employment, and whether it is more profitable to be inactive and receive social support than to have formal employment.

The model shows that there are negative incentives for formalization that have come into existence as a consequence of the design of the system of social support and family benefits. The design of the system is such that the beneficiaries of social support are not interested in working at all, or if they do work it is not attractive for them to formalize their work, since for every euro that the beneficiary of social support earns in Montenegro, he/she loses more than one euro in the form of social support. This results in a marginal effective tax rate (METR) that is higher than 100%.¹¹⁶

These disincentives to formalize their work that the beneficiaries of social transfers have are widely recognized. It is this argument that both individuals and representatives of the business sector use as one of the key obstacles to formalization (64% of the total number of employers).

Maximizing the benefits from the formal sector and informal employment is particularly emphasized in the case of material allowances for families. One-quarter of the beneficiaries of material allowances for families are engaged in informal jobs, which ensures that they receive benefits and use a whole range of other privileges (subsidies for electricity bills, child allowances, financial support for purchasing textbooks, etc.). At the same time this group of users uses the most generous transfers, since these are people who are able to work, who have children who are minors. Through this form of engagement/manipulation of the system, out of the total expenditure on social transfers (including pensions), approximately 10% every year is “wrongly” targeted. That is why it is so important to develop a system and measures to motivate the beneficiaries of social care to formalize their work engagement.

115 The technical assistance project “Removing disincentives for work”, by experts Jan Rutkowski, Johannes Koettl, Boryana Gotcheva, Zoran Anušić.

116 In using insurance through a household member or through some other programme of social care and participating in the informal economy, undeclared employees partly use the benefits of the formal economy as well. The fact that they use social care benefits, particularly social assistance while being informally employed ensures that the beneficiaries can maximize benefits and this reduces incentives for formalization of their activities.

This should include measures that would lead to the gradual reduction of social care benefits for people who formalize their work engagement, with the possibility of a “grace period” in which they would also obtain additional symbolic benefits.¹¹⁷

The regulatory framework should be encouraging for formalization

In spite of significant improvements, the regulatory framework in Montenegro is still inflexible. It is characterized by large administrative barriers, some of them being a consequence of unselective and verbatim transferring of EU legislation that is not adjusted to the local economic circumstances. Some regulatory policies are absolutely contrary to incentives for formal employment.

Thus, for example, before 2008 retired people who wanted to increase their income were not in a position to do so through any kind of engagement in the formal economy. It was the same for students who were recipients of family pensions before 2010. Montenegrin legislation contains another anomaly of this kind. Students whose education process is financed by the state and have a student loan or any form of scholarship lose their right to finances if they find formal employment during the school year or even between terms. This policy and provisions in the legislation stimulate work within the informal sector and have a negative impact on work engagement.

The structure of informally employed people (mostly elderly people) shows that by providing privileges to certain groups (early pensions, disability pensions, social transfers, etc.) the system creates motivation and an environment for a high percentage of informally employed people. That is why certain legal provisions that are related to partial individual rights of certain social or interest groups should be carefully analysed in the context of their impact on the labour market and informalities.

There are concerns caused by frequent changes in policies that are not part of a systemic approach, but often *ad hoc* solutions motivated by particular interests or the need to score political points. Often these measures come as a product of the good intentions of their creators, but without consideration of the bigger picture and long-term consequences of their implementation. Thus, regulatory changes in the social care system that were adopted in 2015 (special requirements for retirement, benefits for mothers and similar benefits) not only pose a fiscal problem, but also create negative incentives for all participants in the labour market. Such a policy sends the message to citizens that it is sufficient to belong to a certain group of employees for them to acquire privileges and “escape” into inactivity and the informal sector. In such circumstances, the pressure to maintain work and work efforts can be lower since a guaranteed income is always there.

¹¹⁷ This is a delicate issue because it can sound like a “reward” for those who (mis)use the social care system, but nevertheless, this might be necessary if Montenegro wants to encourage formalization, particularly for individuals who have been using social support for years and have had informal employment in parallel. Some incentives have already been introduced. Thus, the Law on Social and Child Care defines a gradual abolition of the right to an allowance for children whose parent, adoptive parent, guardian, foster parent or the person entrusted with the child’s care, upbringing and education is the recipient of material allowance for families and has become employed on the basis of the agreement on active overcoming of the unfavourable social situation for a period of nine months (additional symbolic benefit).

Labour legislation should be more flexible

Members of the working population and employers have contradictory opinions about Montenegrin labour legislation. According to the Survey results, the working population in Montenegro predominantly thinks that the rights of workers are endangered, and that employers are in a privileged position. A total of 79% of the working population think that the Labour Law protects the interests of employers more than the interest of workers, while 13% are of the opinion that the Labour Law is more on the side of workers. As expected, the opinions of representatives of companies are different – those who think that the Law protects the rights of workers more are approximately the same in size as those who think that the Law is more on the side of employers (43%).

Unions of employers in Montenegro agree that labour legislation is focused on the protection of employed people in their workplaces and that it does not promote flexibility, new forms of labour and mobility, as key elements for enhancing the skills and competencies of employed people i.e. human capital. They see labour legislation and related regulations in the field of labour relations as a “significant obstacle to achieving the maximum effects of capital investments and the creative work of employed people”. In their opinion, “the Labour Law contains incompletely and poorly stipulated rights and duties in the field of labour relations, which leaves room for abuse and contradictory interpretations of the same legal provisions. This leads to numerous labour disputes and long-term court proceedings that in almost all cases end up in judgments against employers”.¹¹⁸

The need to improve labour regulations in Montenegro is also recognized in the reports of the relevant international organizations. The 2014 Progress Report noted that additional flexibility should be introduced into the labour market. The World Bank document “Preparation for Prosperity” notes that the ability of an economy to respond flexibly to changes is extremely important for economic results and that flexibility is higher if employed people are not “trapped” into narrow specializations and if they are prepared for mobility and the acquisition of new skills. In one of the conclusions it is noted that the Government should continue improving its regulation of the labour market in order to avoid disincentives for the generation of new jobs.

Research by the OECD (OECD, 1999, 2004 and 2006) shows that rigid legislation in the labour market influences the maintenance of the level of unemployment as well as higher unemployment among women, the young and elderly men. In countries that have strict labour legislation, the activity rate and employment rate are lower, while the proportion of self-employed people out of the total number of employed people is higher.

¹¹⁸ Representatives of the Chamber of Commerce of Montenegro, Montenegro Business Alliance, Union of Employers, Council of Foreign Investors and American Chamber of Commerce in Montenegro on 17 November 2014 signed a Memorandum of Understanding aimed at improving the business environment in the field of labour legislation. The above statement is what the Secretary General of the Chamber of Commerce stated on the occasion of signing the Memorandum.

In Montenegro the level of employment protection is relatively high, in comparison to the EU and OECD countries, with a value of 3.2 (in the range from 0 to 6, where 0 is flexible regulation and 6 is rigid regulation).¹¹⁹ Additionally the Severance Pay Generosity Index (Dolanc, 2012) shows that among the countries of South-East Europe, Montenegro has the most generous severance pay system.¹²⁰ Additionally, if we observe the provisions of branch-level collective agreements and collective agreements at the level of employers, which usually give a larger scope of rights, we can see that the severance pay is even more generous in some cases. Regardless of the fact that at the first sight this legislation appears to be provide privileges and protection for employed people against losing their job, at the same time it might be one of the causes for the high percentage of informally employed people in the formal sector, i.e. it might be a constraint to generating more formal jobs.¹²¹

Additionally, given the findings of the Survey related to the income levels of informally employed people, that are at the level of the minimum wage, the amount and use of the minimum wage should be considered from the aspect of the incentive it can provide for informality and from the aspect of the obstacles it can cause to the creation of new jobs in the formal economy. This should be done particularly since there are large regional differences, especially in the level of salaries and the possibilities for the companies to make profit.

Higher mobility between jobs means enhancing human capital through enhancing the skills and competences of employed people. Attachment to one job mostly means stagnation and an inability to adapt to changed circumstances, which was what happened to a large number of employed people in Montenegro when the transition process started. In the pre-transition period, which is not a feature of transition economies only, the probability that employees would enter retirement at the company where they started working was high. Today such a practice is inconceivable.

Based on the principle “less is more”, the framework of rights from the Labour Law should promote the key rights of employed people and move the focus from job security to employment security. It would increase flexibility in the labour market and mobility between jobs and employers.

119 Although it brought improvements in some of its provisions, the Labour Law of 2003 assumed a high level of protection of employed people. The value of the EPL index, which ranges from 0 to 6 (0 is flexible regulation, 6 is rigid legislation), was 4.2. Reform of labour legislation from 2008 led to an increase of flexibility, primarily through regulation that is related to the use of fixed-term contracts, so that the index of legal protection of employment reduced by 1.7. Although reform of legislation from 2011 did improve labour legislation in certain aspects, particularly in the field of severance pay, influenced an increase in the value of the EPL index to 3.2 (MF, 2014) primarily due to the limitations on the use of fixed-term contracts.

120 The Severance Pay Generosity Index is measured on the basis of the amount of severance pay after one year of work, five years of work and 10 years of work. The value of the index is the number of weekly wages per year of work that an employed person is entitled to in case of termination of labour contract.

121 A generous severance pay system reduces the intensity of flows in the labour market and discourages employers from introducing new technologies (Holzman, Vodopivec, 2012).

The public sector must be more efficient and more “fair”

Countries with higher tax revenues that are achieved with lower tax rates with less regulations, a better rule of law and lower corruption levels have a lower level of the informal economy. The efficiency of the public sector has an indirect effect on the scale of the informal economy because it influences tax morale. Taxpayers are more inclined to pay taxes honestly if they get valuable public services in return. However, taxpayers comply more “neatly” and more “voluntarily” if they feel that the laws are applied in an unselective and fair manner. Better tax morale and social norms can lead to a reduction in the probability that individuals will work in the grey economy.

A significant source of growth in the burden of legislation, and thus also an encouragement for doing business in the informal economy, is the uncritical and non-selective “copying” of international practice with a view to achieving faster integration into international organizations and initiatives. In that sense, the process of European integration constitutes a particularly important driver for development of new legislation in Montenegro. It is not rare, in their wish to ensure harmonization with European directives and recommendations, for decision-makers to “rush” into integration and introduce standards that are inapplicable in Montenegro, because of the stage in the development of the Montenegrin economy or due to the lack of capacities. This has created quite significant barriers, both for businesses and for the effective operation of the administration. In spite of the declared commitment of governments, particularly those of EU Member States, to reduce the administrative burden and in spite of the slogan “one in, two out”, it seems that, in the end, this initiative has been reduced to decreasing the number of pieces of legislation by creating new, more complicated ones, which bring in more obligations for businesses and entrepreneurs.

It is important to continue the process of the reform of public administration and the process of regulatory reform, which will not necessarily mean fewer employees in the public sector and a smaller volume of regulations, but will lead to the professional, non-discretionary and efficient work of employees with regulations that are understandable and applicable. There is something that seems to be even more important than the initiative to abolish unnecessary laws, and that is the prevention of the adoption of new, illegible and inapplicable laws that are in collision with the existing ones.

Tax policy should serve the function of creating preconditions for generating new jobs and for gradual formalization

The correlation calculated on the basis of the data from the Survey shows the direction of changes in employment in the formal sector under the influence of changes in the tax burden. The correlation between the tax burden and the total number of formally employed people in Montenegro is negative and statistically significant. This means that every increase in the tax burden has a negative impact on employment in the formal sector. This data can be interpreted in such a way that every increase in

the tax burden influences the decision of employers on whether to hire employees or not and possibly whether to hire employees informally.

An increase in the tax burden means an increase related not only to new employees but also to the existing ones, i.e. it means an increase in labour costs, which can have an additional negative impact on a reduction of the number of jobs in the formal sector and a smaller number of new jobs. At the same time, an increase in the tax burden at the macro level leads to a lower competitiveness of the economy. And the same is true vice-versa. A negative correlation between employment in the formal sector and the tax burden indicates the fact that a reduction in the tax burden increases employment in the formal sector.

Since 2004, tax policy reforms, primarily the reform of taxation of income and profit, have had a positive impact on tax morale and the scale of the informal economy. The available data shows that the scale of undeclared employment in absolute figures is fairly constant, while there is a significant growth in formal employment.¹²²

The consequences of a decrease in the total tax burden on the labour costs¹²³ are manifested in an increase in tax discipline and growth in the collection of income tax. A reduction in the effective tax rate in the period from 2004 to 2008 by approximately 10 percentage points resulted in a growth in income from income tax of almost 100%. In addition to the effective income tax rate, in the period since 2004 the total tax burden on labour costs has also been reduced through the reduction of rates for contributions for compulsory social insurance (from a total of 24% to 20.5% for pension insurance and from a total of 14% to 12.3% for health insurance, whereby half of the costs were paid by the employer and half by the employee).¹²⁴

In spite of the reductions in the tax burden on labour costs effected over the last decade, the tax burden in Montenegro is still 3pp higher than the average in the European Union (36.7%) and it is 4pp higher than in countries that are members of the Eurozone (35.5%). The average tax burden of labour costs in Montenegro is 5pp higher than the average for the OECD member countries (34.8%) that are the most developed economies in the world. This difference is even more significant if we compare the reliefs and exemptions that are applied in the tax regulations of developed countries and those applied in Montenegro.

122 In the period since 2002 the effective tax rate has been reduced by 10pp (approximately one-fifth), while formal employment increased by approximately one-quarter (23.7%)

123 The tax burden of labour costs is an indicator of the ratio between the costs of net salaries and compulsory taxes and contributions. The tax burden shows how much of each euro spent on labour costs goes to employed people, and how much is paid in the form of taxes and contributions.

124 In 2010 the structure of the burden changed. The contributions that are to be paid by the employee increased, while those to be paid by the employer decreased. This change led to the situation where the majority of employers kept net earnings at a constant level and increased gross salaries, which in turn led to an increase in the overall tax burden on labour costs, since gross salaries constitute the basis for calculation of the employer's part of the contribution.

The Survey has shown that for representatives of the business community, the question of tax is the key question. Ranking the challenges and obstacles for the formalization of employment, a dominant number of representatives of the business community said that the key constraints were the amount of taxes, contributions, parafiscal charges and VAT deadlines.

In addition to the level of the tax burden, the administrative burden - the cost of paying taxes - is also a particularly important part of the tax system from the perspective of formalization. Regardless of whether tax rates are low, if it is administratively complicated and expensive to pay taxes, and in addition to this, if discretionary and variable calculation rules are still in force, then the total system is expensive and irrational, both for the state and for the taxpayer.

Relevant studies show that in Montenegro it is very complicated to pay taxes, particularly if you are an individual or a self-employed person. One of the sub-indicators of the Ease of Doing Business Index is the paying taxes index.¹²⁵ If we observe only the total tax rate as a percentage of profit, then Montenegro is 23rd out of 189 countries. However, if we include the indicators of the number of payments, procedures and the time required for calculating, reporting and paying taxes, Montenegro is 98th out of 189 countries. An average small enterprise spends 320 hours and takes in total 29 hours a year to comply with the tax legislation.

One of the problems that companies in Montenegro face, according to the Survey, is VAT legislation, particularly the part referring to VAT refunds and the procedure related to it. If a company acquires the right to a VAT refund, the period within which the state must administer it is 60 days. However, since the tax authorities send their auditors within the procedure before issuing a tax refund, it can sometimes take as long as six months to obtain the refund. Detailed research (Bošković, 2015) conducted in Montenegro shows that application of VAT legislation, in addition to the above, also generates high administrative costs that are related to the need to calculate, document, archive and report VAT. These costs are roughly 18% of the total revenue from VAT. This means that through compliance with VAT legislation, in addition to the approximately €500 million that is annually paid in the form of tax, companies have an additional cost of about €100 million that could be used in a much more productive way.

If an individual wants to report and pay taxes, e.g. on the income from additional work or on any other income, he/she will have to provide a statement from his/her employers about the income that was made in the previous year, fill out an unclear and complicated form and wait for the decision of the Tax Administration about the tax he/she has to pay.

If an individual wants to register and pay taxes as a self-employed person, he/she has to keep business books and additionally pay taxes and contributions for the generated income, a minimum amount of 40% of the average salary in Montenegro, which is the minimum wage at the moment. Although the

¹²⁵ Doing Business index.

concept of the minimum wage is completely different and serves for the protection of the minimum income of employed people, in Montenegro it is commonly understood as a parafiscal instrument. Since the increase in the minimum wage in 2013 (from the pre-2013 level of 30% of the average wage), the amount of tax debt for taxes and contributions significantly increased. Additionally, the concept of the minimum wage in Montenegrin conditions is acquiring a new dimension from the perspective of formalization. Research shows that the average income of self-employed people, who make up a half of all undeclared employed people, is at the level of the minimum wage without any taxes or contributions.

Thus solution of the tax issues is one of the priorities of the formalization process. In the short run, Montenegro needs to undertake measures that will not have a negative impact on the budget and that will help to relieve businesses of the burden of employment and encourage employment and the formalization of employment. Minor parafiscal charges at the central and local levels should be analysed through the lens of budget revenues and the costs of their collection/payment. In all the situations where incomes are lower than costs or slightly higher, parafiscal charges should be abolished. The deadlines for tax refunds should also be reduced to a minimum. This primarily includes the deadline for the refund from the moment of filing the request. As a rule this results in a long tax audit that exceeds the formal deadline for a refund. The procedure for and costs of paying taxes should be made more efficient and inexpensive.

In the medium term, when the fiscal space is created, the tax burden on labour should be reduced through a reduction of income tax and/or contributions, at least by 5 percentage points so that it reaches the level of the most developed countries.

Montenegro should consider the option whereby informally self-employed people (whose level of income is below a certain level) can choose the services from the state that they want to use and pay insurance for.

Before the unified registration and collection of taxes and contributions was introduced, farmers used the option to pay for health insurance at an annual level. From a financial point of view, for them, it was an acceptable cost, which was on average the level of the average monthly salary in Montenegro. When the unified registration was introduced, this option was abolished. Farmers and other individuals that were not interested in the system of pension insurance simply stopped paying contributions for health insurance. Therefore, Montenegro should consider a system in which individuals - informally self-employed people - would be able to choose the state services that they want to use and would pay the insurance and contributions at the full or a reduced rate.

From the aspect of the “voluntariness” of paying insurance and contributions, there is a particularly delicate issue that is connected with the pension system. The current system of inter-generation

solidarity¹²⁶ is not sustainable, particularly given the negative demographic trends. Payment of contributions to pay pensions to the current retired population is not a guarantee of a “secure” pension in old age. Therefore, as such, the pension system cannot motivate people towards formalization, i.e. the payment of contributions. In that context Montenegro should consider measures that would make voluntary payment of the pension insurance by certain groups in the labour market (like self-employed people) more attractive.

The work of inspection bodies and enforcement of penalties should be improved

More than a half of employers think that the benefits from informal employment are higher than the envisaged penalties. In 39% of the companies that employ undeclared workers and had penalties imposed on them, the employers think that those imposed penalties were lenient. In that context, since the burden of formal work is too high, employers will rather risk penalties than register their employees.

Employers also justify this behaviour by their perception that there is a low probability that they will be punished. This confirms the findings of empirical studies in other countries about the effects of “intimidation”.

Particularly concerning is the fact that one in six companies managed to avoid the attention of the Labour Inspectorate and that one in five of those companies engaged in informal employment which was punished, in the end found a way to avoid paying the penalty. This means that, although the Labour Inspectorate audited 83% of companies that are engaged in informal employment, only 18.4% of all of them were punished. Employers themselves say that they have heard of or experienced cases where the inspectors do make a report, but the process gets suspended in part of the chain and the penalties are never enforced.

The most serious complaint that the business sector makes about the work of the inspection bodies is that they are susceptible to corruption. An argument that supports their complaint is the finding that a half of the employers say that very frequently or frequently they hide their non-payment of penalties by bribing the inspectors, and almost one-third of employers think that it happens occasionally.

Particular attention should be paid to the practice and conduct of the inspections, in terms of their approach to the objects of the inspection and the (non-)imposition of penalties. An increasing number of employers complain about the selective approach of the inspection bodies, different interpretations of legislation by the inspections depending on the individual inspectors, and about the large degree of discretion on the side of the inspectors. That is why the work of the inspection bodies, their penalty policies and enforcement should be thoroughly analysed and measures for ensuring that their work

¹²⁶ In addition to the compulsory pension system of inter-generation solidarity, in Montenegro the Law on Voluntary Pension Funds created preconditions for additional pension insurance on the basis of individual capitalized savings.

is efficient and effective should be designed. It seems it would be useful to consider modalities for developing stronger trust and better cooperation among the inspection bodies and social partners, particularly representatives of the trade unions, that acknowledge the problems in their work and conduct.

Instead of putting the focus on intimidation, it should be put on education and development of a culture of trust

The Granger causality test shows that the scale of the informal economy has an impact on a policy of intimidation, i.e. the higher the level of the informal economy, the more government policy is based on promoting penalty policies, while the policy of intimidation itself does not have an impact on the reduction of the informal economy. Still, empirical studies show that repressive mechanisms do not have any positive impact on the formalization of informal work.

An institutional approach to combating informal employment in Montenegro is rather highly based on intimidation and penalty policies, as well as on additional regulation aimed at combating the grey economy. One of the basic goals, in addition to the goal of reducing informal employment, was to increase budget revenues. It is not enough to take into account only the lost revenue of the state and not to take into account other consequences. It does not provide us with the whole picture. Ultimately, insisting on repressive measures to enact a formal transfer from the informal to the formal sector could have a negative effect on the economic and social system in Montenegro

According to the IPSOS Survey, if for all those who are partly or fully informally engaged, all duties were calculated and paid to the state, the state budget would have an additional revenue of €140 million. This would at the same time lead to additional costs for economic entities or a smaller income for those people who are (or were) informally employed. It is very likely that a repressive policy aimed at formalization without changing the system of incentives would lead to a reduction of economic and work engagement and as a consequence lead to an increase in poverty.

Also, if we analyse the work of inspection bodies in Montenegro and their work plans and reports, we get the impression that the emphasis is on a strategy of “intimidation” and punishment, as well as that insufficient attention is dedicated to education of the relevant entities. Education of the relevant entities becomes particularly important in intensive regulatory activity, as is the case with Montenegro, particularly at the time of amendments to legislation with a view to ensuring harmonization with European legislation. A culture of partnership between inspectorates and employers should be developed and the focus should be on prevention and not on sanctions.

The population’s tax morale will not improve if trust in the institutions is low and if the belief in the existence of corruption in the public sector and among inspectors is widespread. Given the limited reach of intimidation policies, the approach of the state has to change significantly and an approach where

a culture of trust is nurtured should be developed. Additionally, modernization of the government and governance, promotion of responsibility for the results as well as a change in the style of governance are required both for managing public finances and for ensuring public services, particularly those that are financed directly from taxes on labour (health insurance and insurance from unemployment).

It is important that citizens perceive the system as just and therefore the following is required (Williams, Horodnic, 2015):

- An improvement of procedural justice - the tax authorities should treat citizens and businesses with respect, impartially and responsibly, and they should focus on a service-oriented approach
- Provision of procedural regularity - individuals have to be convinced that the tax rate they pay is fair in comparison to what others pay
- Establishing of redistributive justice, in such a way that citizens are convinced that for the taxes that they pay they get an appropriate quality of service from the public sector

Education of taxpayers and development of a culture of trust are particularly important to ensure that the overall measures for the reduction of informal employment can have a longer-term effect through the reduction of asymmetry between the formal and informal institutions. Changes in the informal institutions, i.e. in the attitudes and perception of citizens about the benefits and threats of informal work, can be achieved through the following:

- An increase in the awareness about the consequences of the lack of formal working history and the advantages and disadvantages of formal/informal work
- Tax education with a view to harmonizing the values with the formal rules and promotion of self-regulation
- An improvement of the policy with a view to ensuring better planning, execution of the budget and measuring of the achieved results, as well as through an increase in the transparency of public spending and visualisation of the budget

At the same time, in order to strengthen trust, but also to ensure more entrepreneurial initiatives and employment, Montenegro should promote an environment where entrepreneurs are respected members of society and good role models for future generations. This is the most difficult task of all. It will require a change in the mindset.

9.2. Compliance of the Recommendations with the 2030 Agenda

The recommendations defined in this document that are aimed ultimately at the formalization of labour and at overcoming exclusion and marginalization, are based on a systemic approach. They are based on the Sustainable Development Goals defined in the Agenda for Sustainable Development by 2030.

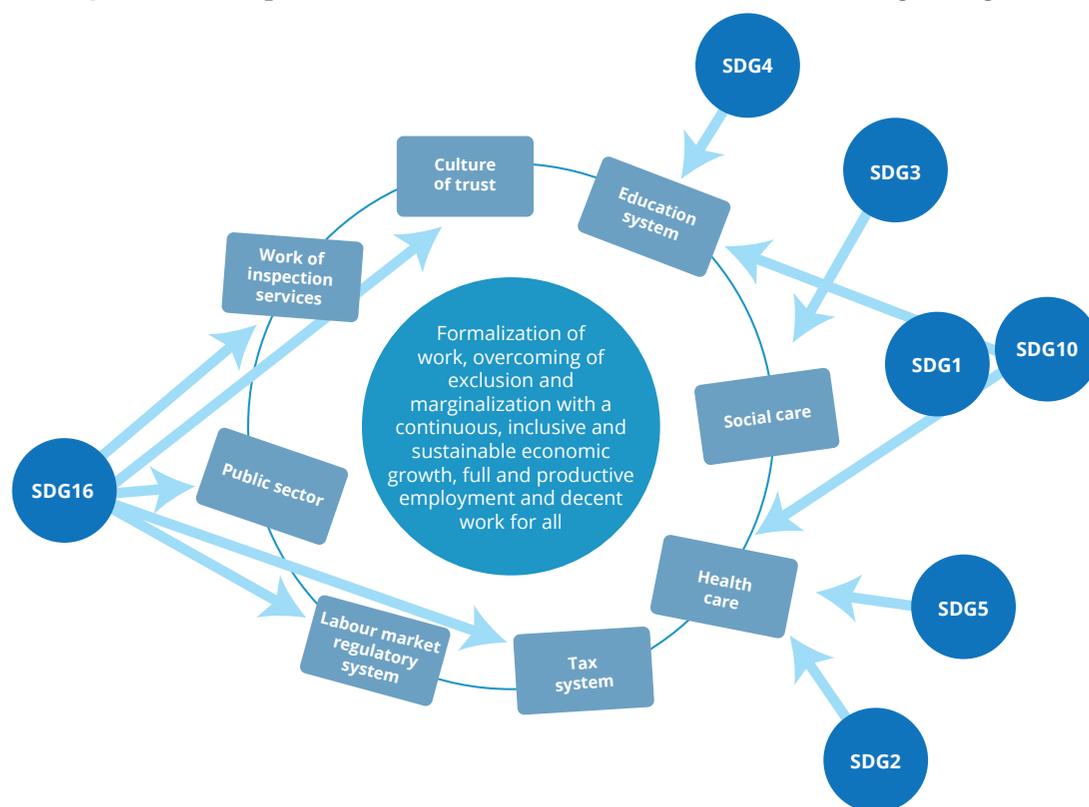
Thus, recommendations that refer to the improvement of the education system to make it more inclusive, of a higher quality and more efficient, and these include an increase in coverage and the level and quality of education, are directly related with Sustainable Development Goal No. 4 (SDG4) – “Ensure inclusive and quality education for all and promote lifelong learning”. Given the fact that the recommendations in this respect particularly focus on acquiring practical knowledge and skills, as well as development of creativity and innovation so that work and entrepreneurship can be a consequence of education, Target 4.4 within SDG4 of the 2030 Agenda can be taken as the crucial one. Taking into account that education is important, not only for decent work and employment, but also for social mobility and a reduction in poverty, the recommendations of this document are also in line with SDGs 1, 8 and 10.

Another aspect that the recommendations of this document focus on is health care that should be more accessible, of a higher quality and more efficient so that it can contribute to the development of human capital, and, as a result, also to a reduction in informal employment. This part of the recommendations is based on SDG3, which refers to ensuring a healthy life and promoting wellbeing for all, at all ages. From the perspective of the NHDR recommendations, it is particularly evident that they are in compliance with Target 3.8, because in its essence it is about achieving universal coverage of health insurance, access to high-quality health services and health institutions.

Recommendations that are aimed at the reform and revision of the social care system in order to make it encouraging for the formalization of jobs and to better target those that need social support, lie in the basis of adequate and high-quality social care that is promoted through several sustainable development goals. Therefore, in order to achieve higher formalization and a better and more efficient social care system that would motivate the formalization of employment, Montenegro needs a more flexible regulatory framework that would not be a burden in terms of administrative obstacles, but an encouraging environment that would reduce the level of informally employed people, increase the mobility of workers (which is the basis of SDG8) and that would focus on security of employment instead on security of a position.

Reducing the volume of the grey economy requires higher efficiency and “fairness” in the public sector, which can be achieved through a stronger rule of law. Target 16.3 within SDG16 of the 2030 Agenda focuses on the rule of law for all, which will, among other things, ensure increases in the efficiency of work, strengthening of integrity, responsibility and transparency in the public sector. More efficient administration and transparent work with clear legislation would lead to better tax morale and an environment with a lower probability of working in the grey economy.

Figure 9.1: Compliance of the recommendations with the 2030 Agenda goals

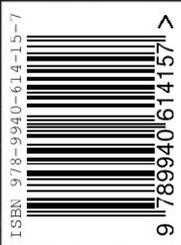


SDG8, as one of the key goals related to employment and the labour market, focuses in its targets on the promotion of entrepreneurship, strengthening of the private sector, encouraging the formalization and growth of micro-, small- and medium-sized enterprises (Target 8.3). In line with these targets, the Report offers the recommendation that tax policy should serve the function of creating the preconditions for generating new jobs and gradual formalization, particularly given the fact that these enterprises account for 99% of all enterprises in Montenegro and that a large tax burden leads to their closing or to informal work, which includes informal employment. Therefore, the work of inspection bodies and the system of enforcement of penalties should be ensured. That would require the strengthening of the capacities of the tax administration, respect for the principles of fairness, transparency, efficiency and effectiveness of the tax system. Higher efficiency in the work of services, as well as the strengthening of the integrity, responsibility and transparency of state services lie in the basis of SDG16, i.e. in Targets 16.3, 16.5, 16.6 and 16.7. Only with stronger institutions and more efficient, more transparent and more motivating work by the relevant authorities, can Montenegro work on enhancing a culture of trust, which means that instead of focusing on deterrence, the focus should be put on education and development of a culture where citizens can perceive the system as fair.

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